BUSN 2275: BUSINESS LAW



Adam Bledsoe
Taft College

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Detailed Licensing

Licensing

*A detailed breakdown of this resource's licensing can be found in **Back Matter/Detailed Licensing**.*

CHAPTER OVERVIEW

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1.1: Introduction

Learning Objectives

- Describe the foundation and sources that establish American law.



Figure 1.1.1: Introduction (Credit: MarkThomas /pixabay /Attribution 2.0 Generic (CC BY 2.0))

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1.2: Basic American Legal Principles

The American legal system has its roots in the British legal system. It was developed with the purpose of establishing standards for acceptable conduct, proscribing punishment for violations as a deterrent, establishing systems for enforcement, and peacefully resolving disputes. The ultimate goal of the American legal system is promotion of the common good.

Establishing Standards

The American legal system was developed with the goal of establishing a set of standards that outline what is to be considered minimally acceptable behavior. Broadly speaking, federal laws are those that all United States citizens are expected to follow. State and local laws may often be similar to federal laws, but they may also differ quite a bit, and only govern the state's citizens.



Figure 1.2.1: The American legal system is designed to establish a set of standards for acceptable behavior. (Credit: joergelman/ pixabay/ License: CC0)

Promoting Consistency

The American legal system follows the British Common Law system, which is designed to leverage past judicial reasoning, while also promoting fairness through consistency. Judges in the Common Law system help shape the law through their rulings and interpretations. This body of past decisions is known as **case law**. Judges use case law to inform their own rulings. Indeed, judges rely on **precedent**, i.e., previous court rulings on similar cases, for ruling on their own cases.

All U.S. states, except Louisiana, have enacted "reception statutes," stating that the judge-made common law of England is the law of the state to the extent that it does not conflict with the state's current laws.

However, the body of American law is now so robust that American cases rarely cite English materials, except for a British classic or a famous old case. Additionally, foreign law is not cited as binding precedent. Therefore, the current American practice of the common law tradition refers more to the process of judges looking to the precedent set jurisdictionally, and substantially similar to, American case law.

Maintaining Order

Congruent with the goal of establishing standards and promoting consistency, laws are also used to promote, provide, and maintain order.

Resolving Disputes

Conflicts are to be expected given people's varying needs, desires, objectives, values systems, and perspectives. The American legal system provides a formal means for resolving conflicts through the courts. In addition to the federal court and individual state systems, there are also several informal means for resolving disputes that are collectively called alternative dispute resolution (ADR). Examples of these are mediation and arbitration.

Protecting Liberties and Rights

The United States Constitution and state laws provide people with many liberties and rights. American laws operate with the purpose and function of protecting these liberties and rights from violations by persons, companies, governments, or other entities.

Based on the British legal system, the American legal system is divided into a federal system and a state and local system. The overall goal of both systems is to provide order and a means of dispute settlement, as well as to protect citizens' rights.

Clearly, the purposes of the American legal system are broad and well-considered.

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1.3: Sources and Types of Law

The American legal system is made up of many types of codified forms of law, with the United States Constitution being the pre-eminent source of American law. The Constitution establishes the boundaries of federal law, and it must be followed by all citizens, organizations, and entities. It includes Congressional acts, Senate-ratified treaties, executive regulations, and federal case law. The United States Code ("USC") compiles these laws.

American law mainly originates from constitutional law, statutory law, treaties, administrative regulations, and common law (which includes case law).

The Constitution

The United States Constitution is the foremost law of the land. The Constitution's first ten amendments are referred to as the Bill of Rights, which offers specific protections of individual liberty and justice. Additionally, the Bill of Rights restricts certain powers of government. The Constitution empowers federal law making by giving Congress the power to enact statutes for certain limited purposes, like regulating interstate commerce. The United States Code officially compiles and codifies the federal statutes.



Figure 1.3.1: The U.S. Constitution is known as the supreme law of the land. (Credit: lynn0101/ pixabay/ License: CC0)

American Common Law

As discussed in the previous section, the United States follows the common law legal tradition of English law. Judges in the Common Law system help shape the law through their rulings and interpretations. This body of past decisions is known as **case law**, which is used by judges to inform their own rulings. In fact, judges rely on **precedent**, i.e., previous court rulings on similar cases, when determining the ruling in their own cases.

An example of how case law works is the case of the State v. Wayfair Inc. (2017 SD 56, 901 N.W.2d 754 (S.D. 2017), cert. granted, 138 S. Ct. 735 (2018)), in which the South Dakota Supreme Court held that a state law requiring internet retailers without an in-

state physical presence to remit sales tax was unconstitutional. Unless this ruling is overruled by the United States Supreme Court, then it becomes part of the case law and precedent set in that state, and it will be followed by subsequent rulings when similar cases are filed.

Federal Law

The Constitution empowers federal law making by giving Congress the power to enact statutes for certain limited purposes, like regulating interstate commerce. Federal law preempts conflicting state and local laws. However, federal preemption is not without limits, insofar as states each have their own constitution and are considered sovereign. Therefore, federal law may only preempt state law if it is enacted within the limited powers that are enumerated and granted to Congress in the Constitution.

Broad interpretations of the Constitution's Commerce and Spending Clauses have expanded the reach of federal law into many areas. Indeed, its reach in some areas, such as aviation and railroads, is now so broad that it preempts virtually all state law. In others areas, such as family law, lawmaking continues to be left to the states. Finally, a number of powerful federal and state laws coexist in areas such as antitrust, trademark, employment law, and others.

Statutes

When a bill becomes a federal law, it is assigned a law number and prepared for publication by the Office of the Federal Register (OFR) of the National Archives and Records Administration (NARA). Public laws are also given legal statutory citation by the OFR and are incorporated into the United States Code (USC).

Regulations

Laws differ from regulations in that laws are passed by either the U.S. Congress or state congresses. Regulations, by contrast, are standards and rules adopted by administrative agencies that govern how laws will be enforced.

Federal agencies often enjoy broad rulemaking authority when Congress acts to grant them this power. Called "regulations," these agency rules normally carry the force of law, as long as they demonstrate a reasonable interpretation of the relevant statutes. For example, the Environmental Protection Agency (EPA) has established regulations for businesses and their emission and disposal of pollutants to protect the environment. The EPA has the authority to enforce these regulations when a business violates them, and such enforcement is usually done by fining the company or by using other means.

The Administrative Procedure Act (APA) enables the adoption of regulations, which are codified and incorporated into the Code of Federal Regulations (CFR). Federal agencies frequently draft and distribute forms, manuals, policy statements, letters, and rulings. Though these may be considered as persuasive authority by the courts, they do not carry the same force as law. In other words, if a person or business questions a regulation of a government agency, saying it is unconstitutional, and that party is successful in proving it, then the regulation is not enforced and the agency will need to revise it or remove it.

State Law

America, as diverse as its fifty states, is also governed by fifty different state constitutions, state governments, and state courts. Each has its own legislative, executive, and judicial branches. States are empowered to create legislation that is related to matters not preempted by the federal Constitution and federal laws. Most cases involve state law issues and are litigated in state courts.

Local Law

In addition to federal and state law, municipalities, towns or cities, and counties may enact their own laws that do not conflict with state or federal laws.

As demonstrated, American law does not draw from one source alone; instead, it is derived from many sources.

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1.4: Important Business Laws and Regulations

Business law is a very expansive area of the law. It primarily addresses issues related to the creation of new businesses, which arise as existing companies deal with the public, government, and other companies. Business law consists of many legal disciplines, including contracts, tax law, corporate law, intellectual property, real estate, sales, immigration law, employment law, bankruptcy, and others.



Figure 1.4.1: Contract law is just one type of law that businesses need to be concerned about. (Credit: edar/ pixabay/ License: CC0)

As noted, business law touches upon a number of other legal areas, practices, and concerns. Some of the most important of these, which are discussed in this section, are disputes and dispute settlement, business ethics and social responsibility, business and the United States Constitution, criminal liability, torts, contracts, labor and employment law, Unfair Trade Practices and the Federal Trade Commission, international law, and securities regulation. Though they are discussed in much more depth in later chapters, the following gives a brief overview.

Disputes and Dispute Settlement

In addition to the federal court and individual state systems, there are also a variety of mechanisms that companies can use to resolve disputes. They are collectively called alternative dispute resolution ("ADR"), and they include mediation, settlement, and arbitration. Many states now require companies to resolve legal disputes using ADR before the initiation of any lawsuit to encourage speedy resolution, cost and time containment, and reduced judicial dockets. Traditional litigation remains an option in most cases if other efforts fail or are refused.

Business Ethics and Social Responsibility

In the routine course of business, employees are often required to make decisions. Business ethics outline the ethical model, or framework, that companies expect employees to follow when making these decisions, as well as the behavior that the companies deem acceptable. Sound and ethical decision making can also help companies avoid legal liability and exposure. Typically, an

ethics code and/or a code of conduct details a company's requirements and guidelines, while also serving as a key corporate governance tool.

In addition to business ethics, companies must also consider their social responsibility and the laws related to it, such as consumer and investor protections, environmental ethics, marketing ethics, and ethical issues in financial management.

Business and the United States Constitution

Since the start of the 20th century, broad interpretations of the Constitution's Commerce and Spending Clauses have expanded the reach of federal law into many areas. Indeed, its reach in some areas is now so broad that it preempts virtually all state law. Thus, the Constitution's Commerce Clause has been interpreted to allow federal lawmaking and enforcement that applies to many aspects of business activity. Additionally, the Constitution's Bill of Rights extends some protections to business entities that are also constitutionally guaranteed to individuals

For example, on January 21, 2010, in Citizens United v. Federal Election Commission, 558 U.S. 310 (2010), the U.S. Supreme Court heard the issue of whether the government can ban political spending by corporations in candidate elections. The Court ruled that corporations have the same Constitutional right to free speech as individuals, and thus lifted the restrictions on contributions.

Criminal Liability

The imposition of criminal liability is one method used to regulate companies. The extent of corporate liability found in an offensive act determines whether a company will be held liable for the acts and omissions of its employees. Criminal consequences may include penalties, such as prison, fines and/or community service. In addition to criminal liability, civil law remedies are usually available, e.g., the award of damages and injunctions, which may include penalties. Most jurisdictions apply both criminal and civil systems.

Torts

Within the business law context, torts may involve either intentional torts or negligence. Additionally, companies involved in certain industries should consider the risk of product liability. Product liability involves a legal action against a company by a consumer for a defective product that caused loss or harm to the customer. There are several theories regarding recovery under product liability. These include contract theories that deal with the product warranty, which details the promises of the nature of the product sold to customers. The contract product warranty theories are Express Warranty, Implied Warranty of Merchantability, and Implied Warranty of Fitness. Tort theories deal with a consumer claim that the company was negligent, and therefore caused either bodily harm, emotional harm, or monetary loss to the plaintiff. The tort liability theories that can be used in this context are negligence (failure to take proper care in something), strict liability (imposition of liability without a finding of fault), and acts committed under Restatement (Third) of Torts (basic elements of the tort action for liability for accidental personal injury and property damage, as well as liability for emotional harm).

Contracts

The main function of a contract is to document promises that are enforceable by law. The key to an agreement or contract is that there must be an offer and acceptance of the terms of that offer. Sales contracts normally involve the sale of goods and include price terms, quantity and cost, how the terms of the contract will be performed, and method of delivery.

Employment and Labor Law

Employment and labor law is a very broad discipline that covers a broad array of laws and regulations involving employer/employee rights and responsibilities in the workplace. This law includes worker protection and safety laws, such as OSHA, and worker immigration laws, such as the Immigration Reform and Control Act, which imposes sanctions on employers for knowingly hiring illegal immigrants. Other notable areas of employment and labor law include, but are not limited to, the National Labor Relations Act, which deals with union and management relations, as well as Equal Opportunity in Employment laws, which provide workers with protections against discrimination in the workplace, e.g., Title VII, the Americans with Disabilities Act, Age Discrimination in Employment Act, and others.

Antitrust Law

Antitrust legislation includes both federal and state laws regulating companies' conduct and organization. The purpose of such regulation is to allow consumers to benefit from the promotion of fair competition. The main statutes implicated by antitrust law are the Sherman Act of 1890, the Clayton Act of 1914, and the Federal Trade Commission Act of 1914. These Acts discourage the restraint of trade by prohibiting the creation of cartels and other collusive practices. Additionally, they encourage competition by restricting the mergers and acquisitions of certain organizations. Finally, they prohibit the creation and abuse of monopoly power.

Actions may be brought in courts to enforce antitrust laws by the Federal Trade Commission ("FTC"), the U.S. Department of Justice, state governments, and private parties.

Unfair Trade Practices and the Federal Trade Commission

The term "unfair trade practices" is broadly used and refers to any deceptive or fraudulent business practice or act that causes injury to a consumer. Some examples include, but are not limited to, false representations of a good or service including deceptive pricing, non-compliance with manufacturing standards, and false advertising. The FTC investigates allegations of unfair trade practices raised by consumers and businesses, pre-merger notification filings, congressional inquiries, or reports in the media and may seek voluntary compliance by offending businesses through a consent order, administrative complaints, or federal litigation.

Securities Regulation

Securities regulation involves both federal and state regulation of securities and stocks by governmental regulatory agencies. At times, it may also involve the regulations of exchanges like the New York Stock Exchange, as well as the rules of self-regulatory organizations like the Financial Industry Regulatory Authority (FINRA).

The Securities and Exchange Commission (SEC) regulates securities on the federal level. Other instruments related to securities, such as futures and some derivatives, are regulated by the Commodity Futures Trading Commission (CFTC).

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1.E: Assessment Questions

1. What country is the United States legal system derived from?
    a. Germany.
    b. United Kingdom.
    c. United States of America.
    d. Canada.

Answer

b

2. What is the function of law in the United States?
    a. Establish standards.
    b. Promote consistency.
    c. Promote, provide, and maintain order.
    d. All of the above.
3. As a judge, Baxter applies common law rules. These rules develop from:
    a. Decisions of the courts in legal disputes.
    b. Regulations issued by administrative agencies.
    c. Statutes enacted by Congress and the state legislatures.
    d. Uniform laws drafted by legal scholars.

Answer

a

4. What is the difference between state and federal law?
5. The legislature of the state of Wyoming enacts a new statute that sets standards for the liability of businesses selling defective products. This statute applies in:
    a. Wyoming only.
    b. Only Wyoming and its bordering states.
    c. All states.
    d. All states but only to matters not covered by other states' laws.

Answer

a

6. Alex has been sued by Will for failure to pay rent for their apartment which source of law will govern this lawsuit?
    a. Administrative law.
    b. The Constitution.
    c. Civil Law.
    d. Criminal Law.
7. Four sources of law in the U.S. legal system are:
    a. Constitutional law, criminal law, civil law, and maritime law.
    b. Federal law, state law, international law, and maritime law.
    c. Statutory law, case law, equity, and common law.
    d. Constitutional law, judicial law, legislative law, and administrative law.

Answer

d

8. Where can you find a codification of federal laws?
    a. The library.
    b. Federal Court.
    c. United States Code.
    d. U.S. Library of Congress.
9. What is the supreme law of the land? What are statutes? What are ordinances? What is an administrative rule?

Answer

What is the supreme law of the land? - The federal constitution is the supreme law of the land.

What are statutes? - Laws enacted by Congress or a state legislative body.

What are ordinances? - Laws enacted by local legislative bodies.

What are administrative rules? - Laws issued by administrative agencies under the authority given to them in statutes.

10. Regulations are:
    a. Laws passed by Congress.
    b. Rules made by local governments.
    c. Derived from decisions made by judges.
    d. Rules adopted by administrative agencies.
11. What is an Unfair Trade Practice and which Administrative Agency regulates it?

Answer

The term “unfair trade practices” is broadly used and refers to any deceptive or fraudulent business practice or act that causes injury to a consumer. Some examples include, but are not limited to, false representations of a good or service including deceptive pricing, non-compliance with manufacturing standards, and false advertising. The FTC investigates allegations of unfair trade practices raised by consumers and businesses, pre-merger notification filings, congressional inquiries, or reports in the media and may seek voluntary compliance by offending businesses through a consent order, administrative complaints, or federal litigation.

12. Some of the rights in the Constitution’s Bill of Rights extends to Corporations.
    a. True.
    b. False.
13. Forms of Alternative Dispute Resolution (“ADR”) include all of the following except:
    a. Mediation.
    b. Settlement.
    c. Litigation.
    d. Arbitration.

Answer

c

14. Consequences of being convicted a crime include all of the following except:
    a. Prison.
    b. Fines.
    c. Community service.
    d. Damages.
15. Securities are only regulated by federal laws.
    a. True.
    b. False.

Answer

b

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CHAPTER OVERVIEW

2: Courts and the Legal Process

Learning Objectives

After reading this chapter, you should be able to do the following:

- Describe the two different court systems in the United States, and explain why some cases can be filed in either court system.
- Explain the importance of subject matter jurisdiction and personal jurisdiction and know the difference between the two.
- Describe the various stages of a civil action: from pleadings, to discovery, to trial, and to appeals.
- Describe two alternatives to litigation: mediation and arbitration.

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.

2.1: Introduction to the Courts and the Legal Process
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2.1: Introduction to the Courts and the Legal Process

As we go through this chapter, consider the case of Harry and Kay Robinson. In which court should the Robinsons file their action? Can the Oklahoma court hear the case and make a judgment that will be enforceable against all of the defendants? Which law will the court use to come to a decision? Will it use New York law, Oklahoma law, federal law, or German law?

Robinson v. Audi

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.

Should the Robinsons bring their action in state court or in federal court? Over which of the defendants will the court have personal jurisdiction?

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2.2: The Relationship between State and Federal Court Systems in the United States

Learning Objectives

After reading this chapter, you should understand the following:

- Understand the different but complementary roles of state and federal court systems.
- Explain why it makes sense for some courts to hear and decide only certain kinds of cases.
- Describe the difference between a trial court and an appellate court.

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, and 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; see Chapter 4). 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 that kind of claim. Third, under the full faith and credit clause, each state court is obligated to respect the final judgments of courts in other states. Thus a contract dispute resolved by an Arkansas court cannot be relitigated 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 conflicts of laws and sometimes decide that they must apply another state's laws to decide the case (see Table 3.1).

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 law. 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 Supreme Court will occasionally take appeals from a state supreme court where state law raises an important issue of federal law to be decided. For 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," raising an Eighth Amendment issue.

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 so-called diversity of citizenship jurisdiction (or diversity jurisdiction). 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 2009, nearly a third of all lawsuits 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).

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.

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 and 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—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.

Limited Jurisdiction Courts

In most large urban states and many smaller states, there are four and sometimes five levels of 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 (no more than $10,000 in most states and far less in many states). 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.

One familiar limited jurisdiction court is the small claims court, with jurisdiction to hear civil cases involving claims for amounts ranging between $1,000 and $5,000 in about half the states and for considerably less in the other states ($500 to $1,000). The advantage of the small claims court is that its procedures are informal, it is often located in a neighborhood outside the business district, it is usually open after business hours, and it is speedy. Lawyers are not necessary to present the case and in some states are not allowed to appear in court.

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, circuit, district, or common pleas court (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 breaches 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 is not a judge, as in the lower courts, but a jury of citizens.

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 were commercial cases, and slightly over 10 percent were devoted to car accident cases and other torts (as discussed in Chapter 7).

Most states have specialized courts that hear only a certain type of case, such as landlord-tenant disputes or probate of wills. Decisions by judges in specialized courts are usually final, although any party dissatisfied with the outcome may be able to get a new trial in a court of general jurisdiction. Because there has been one trial already, this is known as a trial de novo. It is not an appeal, since the case essentially starts over.

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 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. For example, 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 the lower court (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: 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 US Supreme Court to issue a writ of certiorari remains a possibility.

The Federal Court System

District Courts

The federal judicial system is uniform throughout the United States and consists of three levels. At the first level are the federal district courts, which are the 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 US District Court for the Southern District of New York (Manhattan). There are forty-four district judges and fifteen magistrates in this district. The district judges throughout the United States commonly preside over all federal trials, both criminal and civil.

Courts of Appeal

Cases from the district courts can then be appealed to the circuit courts of appeal, of which there are thirteen (Figure 3.1). Each circuit oversees the work of the district courts in several states. For example, the US Court of Appeals for the Second Circuit hears appeals from district courts in New York, Connecticut, and Vermont. The US 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 US 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 (see Chapter 5). The US Court of Appeals for the Federal Circuit, also located in Washington, 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 the US Tax Court, the Court of Customs and Patent Appeals, and the Court of Claims.

United States Supreme Court

Overseeing all federal courts is the US Supreme Court, in Washington, DC. It consists of nine justices—the chief justice and eight associate justices. (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. In 2008, the Supreme Court had numerous petitions (over 7,000, not including thousands of petitions from prisoners) but heard arguments in only 87 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.



Figure 3.1 The Federal Judicial Circuits

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 sit for life unless they voluntarily retire or are impeached.

Key Takeaway

Trial courts and appellate courts have different functions. State trial courts sometimes hear cases with federal law issues, and federal courts sometimes hear cases with state law issues. Within both state and federal court systems, it is useful to know the different kinds of courts and what cases they can decide.

Exercises

1. Why all of this complexity? Why don’t state courts hear only claims based on state law, and federal courts only federal-law-based claims?
2. Why would a plaintiff in Iowa with a case against a New Jersey defendant prefer to have the case heard in Iowa?
3. James, a New Jersey resident, is sued by Jonah, an Iowa resident. After a trial in which James appears and vigorously defends himself, the Iowa state court awards Jonah $136,750 dollars in damages for his tort claim. In trying to collect from James in New Jersey, Jonah must have the New Jersey court certify the Iowa judgment. Why, ordinarily, must the New Jersey court do so?

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2.3: The Problem of Jurisdiction

Learning Objectives

By the end of this section, you will be able to:

- Explain the concept of subject matter jurisdiction and distinguish it from personal jurisdiction.
- Understand how and where the US Constitution provides a set of instructions as to what federal courts are empowered by law to do.
- Know which kinds of cases must be heard in federal courts only.
- Explain diversity of citizenship jurisdiction and be able to decide whether a case is eligible for diversity jurisdiction in the federal courts.

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 in each case that must be answered before a judge will hear a case: the question of subject matter jurisdiction and the question of personal jurisdiction. 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.

The Federal-State Balance: Federalism

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. 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 US Constitution that spells out the respective spheres of authority (jurisdiction) between state and federal courts.

Take a close look at Article III of the Constitution. (You can find a printable copy of the Constitution at http://www.findlaw.com.) 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 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). 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 is diversity jurisdiction, discussed later.

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. Since states sanction marriages and divorce, state courts would deal with "domestic" (family) issues. 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. You wouldn't go to the federal building or courthouse to get a marriage license, ask for a divorce, or probate a will: these matters have traditionally been dealt with by the states (and the thirteen original colonies before them). 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. 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.

In terms of subject matter jurisdiction, then, state courts will typically deal with the kinds of disputes just cited. Thus if you are Michigan resident and have an auto accident in Toledo with an Ohio resident and you each blame each other for the accident, the state courts would ordinarily resolve the matter if the dispute cannot otherwise be settled. Why state courts? Because when you blame one another and allege that it's the other person's fault, you have the beginnings of a tort case, with negligence as a primary element of the claim, and state courts have routinely dealt with this kind of claim, from British colonial times through Independence and to the present. (See also Chapter 7 of this text.) 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.

Always remember: 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.

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!)

Exclusive Jurisdiction in Federal Courts

With two court systems, a plaintiff (or the plaintiff's attorney, most likely) must decide whether to file a case in the state court system or the federal court system. Federal courts have exclusive jurisdiction over certain kinds of cases. The reason for this comes directly from the Constitution. Article III of the US Constitution provides the following:

The judicial Power shall extend to all Cases, in Law and Equity, arising under this Constitution, the Laws of the United States, and Treaties made, or which shall be made, under their Authority; to all Cases affecting Ambassadors, other public Ministers and Consuls; to all Cases of admiralty and maritime Jurisdiction; to Controversies to which the United States shall be a Party; to Controversies between two or more States; between a State and Citizens of another State; between Citizens of different States; between Citizens of the same State claiming Lands under Grants of different States, and between a State, or the Citizens thereof, and foreign States, Citizens or Subjects.

By excluding diversity cases, we can assemble a list of the kinds of cases that can only be heard in federal courts. The list looks like this:

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 arising between foreign ambassadors and other high-ranking public officials.
3. *Federal crimes*. Crimes defined by or mentioned in the US 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*
    1. *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 nonobvious.
    2. *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.
    3. *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: 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.

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. The Supreme Court has now made clear that 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 be 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. (See Note 3.18 "Summary of Rules on Subject Matter Jurisdiction".)

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.

Summary of Rules on Subject Matter Jurisdiction

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 US Constitution)ORA federal court will have subject matter jurisdiction over any case based on state law where the parties are (1) from different states and (2) the amount in controversy is at least $75,000.(1) The different states 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 as between all plaintiffs and defendants.

   (2) The amount in controversy requirement means that a good-faith estimate of the amount the plaintiff may recover is at least $75,000.

   NOTE: For purposes of permanent residence, a corporation is considered a resident where it is incorporated AND where it has a principal place of business.

4. In diversity cases, the following rules apply.(1) Federal civil procedure rules apply to how the case is conducted before and during trial and any appeals, but(2) State law will be used as the basis for a determination of legal rights and responsibilities.(a) This "choice of law" process is interesting but complicated. Basically, each state has its own set of judicial decisions that resolve conflict of laws. For example, just because A sues B in a Texas court, the Texas court will not necessarily apply Texas law. Anna and Bobby collide and suffer serious physical injuries while driving their cars in Roswell, New Mexico. Both live in Austin, and Bobby files a lawsuit in Austin. The court there could hear it (having subject matter jurisdiction and personal jurisdiction over Bobby) but would apply New Mexico law, which governs motor vehicle laws and accidents in New Mexico. Why would the Texas judge do that?

   (b) The Texas judge knows that which state's law is chosen to apply to the case can make a decisive difference in the case, as different states have different substantive law standards. For example, in a breach of contract case, one state's version of the

Uniform Commercial Code may be different from another's, and which one the court decides to apply is often exceedingly good for one side and dismal for the other. In *Anna v. Bobby*, if Texas has one kind of comparative negligence statute and New Mexico has a different kind of comparative negligence statute, who wins or loses, or how much is awarded, could well depend on which law applies. Because both were under the jurisdiction of New Mexico's laws at the time, it makes sense to apply New Mexico law.

(3) Why do some nonresident defendants prefer to be in federal court?

(a) In the state court, the judge is elected, and the jury may be familiar with or sympathetic to the "local" plaintiff.

(b) The federal court provides a more neutral forum, with an appointed, life-tenured judge and a wider pool of potential jurors (drawn from a wider geographical area).

(4) If a defendant does not want to be in state court and there is diversity, what is to be done?

(a) Make a motion for removal to the federal court.

(b) The federal court will not want to add to its caseload, or docket, but must take the case unless there is *not* complete diversity of citizenship or the amount in controversy is *less than* $75,000.

To better understand subject matter jurisdiction in action, let's take an example. Wile E. Coyote wants a federal judge to hear his products-liability action against Acme, Inc., even though the action is based on state law. Mr. Coyote's attorney wants to "make a federal case" out of it, thinking that the jurors in the federal district court's jury pool will understand the case better and be more likely to deliver a "high value" verdict for Mr. Coyote. Mr. Coyote resides in Arizona, and Acme is incorporated in the state of Delaware and has its principal place of business in Chicago, Illinois. The federal court in Arizona can hear and decide Mr. Coyote's case (i.e., it has subject matter jurisdiction over the case) because of diversity of citizenship. If Mr. Coyote was injured by one of Acme's defective products while chasing a roadrunner in Arizona, the federal district court judge would hear his action—using federal procedural law—and decide the case based on the substantive law of Arizona on product liability.

But now change the facts only slightly: Acme is incorporated in Delaware but has its principal place of business in Phoenix, Arizona. Unless Mr. Coyote has a federal law he is using as a basis for his claims against Acme, his attempt to get a federal court to hear and decide the case will fail. It will fail because there is not complete diversity of citizenship between the plaintiff and the defendant.

Robinson v. Audi

Now consider 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 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.

Table 2.3.1: Sample Conflict-of-Law Principles

Substantive Law Issue	Law to be Applied
Liability for injury caused by tortious conduct	State in which the injury was inflicted
Real property	State where the property is located
Personal Property: inheritance	Domicile of deceased (not location of property)
Contract: validity	State in which contract was made
Contract: breach	State in which contract was to be performed*
*Or, in many states, the state with the most significant contacts with the contractual activities	
Note: Choice-of-law clauses in a contract will ordinarily be honored by judges in state and federal courts.	

Legal Procedure, Including Due Process and Personal Jurisdiction

In this section, we consider 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.

The courts are not the only institutions that can resolve disputes. In Section 3.8, 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.

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 he therefore will ignore it. Unlike other branches of government that are free to ignore problems pressing upon them, judges *must* decide cases. (For 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 his 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. Also, judges are bound by standards of weighing evidence: the burden of proof in a civil case is generally a "preponderance of the evidence."

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 his case. If he fails to prove it, 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 most of the cases in this book—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 they 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. To these rules we now turn.

How a Case Proceeds

Complaint and Summons

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

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. 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 superior court, since federal courts have exclusive jurisdiction over copyright cases.

The second consideration is venue—the proper geographic location of the court. For example, every county in a state might have a superior court, but the plaintiff is not free to pick 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).

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). The rules spell out a variety of ways by which individuals and corporations can be served. These include using US Postal Service certified mail or serving someone already designated to receive service of process. A corporation or partnership, for example, 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. For instance, 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. In *Burger King v. Rudzewicz*, Section 3.9, the federal court in Florida had to consider whether it was constitutionally permissible to exercise personal jurisdiction over a Michigan franchisee.

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.

Summary of Rules on Personal Jurisdiction

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.
    1. 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.
    2. The court's decision in the first lawsuit (against defendant 1) does not determine the liability of the nonparticipating defendants.

    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, as to 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).
    1. In order to get a judgment in a civil action, the plaintiff must serve a copy of the complaint and a summons on the defendant.
    2. There are many ways to do this.
        - The process server personally serves a complaint on the defendant.
        - The process server leaves a copy of the summons and complaint at the residence of the defendant, in the hands of a competent person.
        - The process server sends the summons and complaint by certified mail, return receipt requested.
        - 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.
    1. Consent. The defendant agrees to the court's jurisdiction by coming to court, answering the complaint, and having the matter litigated there.
    2. Domicile. The defendant is a permanent resident of that state.
    3. 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!"
    4. Service of process within the state will effectively provide personal jurisdiction over the nonresident.

Again, let's consider Mrs. Robinson and her children in the Audi accident. She could file a lawsuit anywhere in the country. 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 "*in personam* jurisdiction," or 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.

Almost 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. The "minimum contacts" test in *Burger King v. Rudzewicz* (Section 3.9) tries to make the fairness mandate of the due process clause more specific. So do other tests articulated in the case (such as "does not offend traditional notions of fair play and substantial justice"). These tests are posed by the Supreme Court and heeded by all lower courts in order to honor the provisions of the Fourteenth Amendment's due process guarantees. These tests are *in addition to* any state long-arm statute's instructions to courts regarding the assertion of personal jurisdiction over nonresidents.

Choice of Law and Choice of Forum Clauses

In a series of cases, the Supreme Court has made clear that it will honor contractual choices of parties in a lawsuit. 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 (see Table 3.1). But 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. For example, 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. For example, 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-form clause and require Harold (or his insurance company) to litigate in San Antonio, Texas.

Key Takeaway

There are two court systems in the United States. It is important to know which system—the state court system or the federal court system—has the power to hear and decide a particular case. Once that is established, the Constitution compels an inquiry to make sure that no court extends its reach unfairly to out-of-state residents. The question of personal jurisdiction is a question of fairness and due process to nonresidents.

Exercises

1. The Constitution specifies that federal courts have exclusive jurisdiction over admiralty claims. Mr. and Mrs. Shute have a claim against Carnival Cruise lines for the negligence of the cruise line. Mrs. Shute sustained injuries as a result of the company's negligence. Mr. and Mrs. Shute live in the state of Washington. Can they bring their claim in state court? Must they bring their claim in federal court?
2. Congress passed Title VII of the Civil Rights Act of 1964. In Title VII, employers are required not to discriminate against employees on the basis of race, color, sex, religion, or national origin. In passing Title VII, Congress did not require plaintiffs to file only in federal courts. That is, Congress made no statement in Title VII that federal courts had "exclusive jurisdiction" over Title VII claims. Mrs. Harris wishes to sue Forklift Systems, Inc. of Nashville, Tennessee, for sexual harassment under Title

VII. She has gone through the Equal Employment Opportunity Commission process and has a right-to-sue letter, which is required before a Title VII action can be brought to court. Can she file a complaint that will be heard by a state court?

3. Mrs. Harris fails to go to the Equal Employment Opportunity Commission to get her right-to-sue letter against Forklift Systems, Inc. She therefore does not have a viable Title VII cause of action against Forklift. She does, however, have her rights under Tennessee's equal employment statute and various court decisions from Tennessee courts regarding sexual harassment. Forklift is incorporated in Tennessee and has its principal place of business in Nashville. Mrs. Harris is also a citizen of Tennessee. Explain why, if she brings her employment discrimination and sexual harassment lawsuit in a federal court, her lawsuit will be dismissed for lack of subject matter jurisdiction.
4. Suppose Mr. and Mrs. Robinson find in the original paperwork with Seaway Volkswagen that there is a contractual agreement with a provision that says "all disputes arising between buyer and Seaway Volkswagen will be litigated, if at all, in the county courts of Westchester County, New York." Will the Oklahoma court take personal jurisdiction over Seaway Volkswagen, or will it require the Robinsons to litigate their claim in New York?

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2.4: Motions and Discovery

Learning Objectives

By the end of this section, you will be able to:

- Explain how a lawsuit can be dismissed prior to any trial.
- Understand the basic principles and practices of discovery before a trial.

The early phases of a civil action are characterized by many different kinds of motions and a complex process of mutual fact-finding between the parties that is known as discovery. A lawsuit will start with the pleadings (complaint and answer in every case, and in some cases a counterclaim by the defendant against the plaintiff and the plaintiff's reply to the defendant's counterclaim). After the pleadings, the parties may make various motions, which are requests to the judge. Motions in the early stages of a lawsuit usually aim to dismiss the lawsuit, to have it moved to another venue, or to compel the other party to act in certain ways during the discovery process.

Initial Pleadings, and Motions to Dismiss

The first papers filed in a lawsuit are called the pleadings. These include the plaintiff's complaint and then (usually after thirty or more days) the answer or response from the defendant. The answer may be coupled with a counterclaim against the plaintiff. (In effect, the defendant becomes the plaintiff for the claims she has against the original plaintiff.) The plaintiff may reply to any counterclaim by the defendant.

State and federal rules of civil procedure require that the complaint must state the nature of the plaintiff's claim, the jurisdiction of the court, and the nature of the relief that is being asked for (usually an award of money, but sometimes an injunction, or a declaration of legal rights). In an answer, the defendant will often deny all the allegations of the complaint or will admit to certain of its allegations and deny others.

A complaint and subsequent pleadings are usually quite general and give little detail. Cases can be decided on the pleadings alone in the following situations: (1) If the defendant fails to answer the complaint, the court can enter a default judgment, awarding the plaintiff what he seeks. (2) The defendant can move to dismiss the complaint on the grounds that the plaintiff failed to "state a claim on which relief can be granted," or on the basis that there is no subject matter jurisdiction for the court chosen by the plaintiff, or on the basis that there is no personal jurisdiction over the defendant. The defendant is saying, in effect, that even if all the plaintiff's allegations are true, they do not amount to a legal claim that can be heard by the court. For example, a claim that the defendant induced a woman to stop dating the plaintiff (a so-called alienation of affections cause of action) is no longer actionable in US state courts, and any court will dismiss the complaint without any further proceedings. (This type of dismissal is occasionally still called a demurrer.)

A third kind of dismissal can take place on a motion for summary judgment. If there is no triable question of fact or law, there is no reason to have a trial. For example, the plaintiff sues on a promissory note and, at deposition (an oral examination under oath), the defendant admits having made no payment on the note and offers no excuse that would be recognizable as a reason not to pay. There is no reason to have a trial, and the court should grant summary judgment.

Discovery

If there is a factual dispute, the case will usually involve some degree of discovery, where each party tries to get as much information out of the other party as the rules allow. Until the 1940s, when discovery became part of civil procedure rules, a lawsuit was frequently a game in which each party hid as much information as possible and tried to surprise the other party in court.

Beginning with a change in the Federal Rules of Civil Procedure adopted by the Supreme Court in 1938 and subsequently followed by many of the states, the parties are entitled to learn the facts of the case before trial. The basic idea is to help the parties determine what the evidence might be, who the potential witnesses are, and what specific issues are relevant. Discovery can proceed by several methods. A party may serve an interrogatory on his adversary—a written request for answers to specific questions. Or a party may depose the other party or a witness. A deposition is a live question-and-answer session at which the witness answers

questions put to him by one of the parties' lawyers. His answers are recorded verbatim and may be used at trial. Each party is also entitled to inspect books, documents, records, and other physical items in the possession of the other. This is a broad right, as it is not limited to just evidence that is admissible at trial. Discovery of physical evidence means that a plaintiff may inspect a company's accounts, customer lists, assets, profit-and-loss statements, balance sheets, engineering and quality-control reports, sales reports, and virtually any other document.

The lawyers, not the court, run the discovery process. For example, one party simply makes a written demand, stating the time at which the deposition will take place or the type of documents it wishes to inspect and make copies of. A party unreasonably resisting discovery methods (whether depositions, written interrogatories, or requests for documents) can be challenged, however, and judges are often brought into the process to push reluctant parties to make more disclosure or to protect a party from irrelevant or unreasonable discovery requests. For example, the party receiving the discovery request can apply to the court for a protective order if it can show that the demand is for privileged material (e.g., a party's lawyers' records are not open for inspection) or that the demand was made to harass the opponent. In complex cases between companies, the discovery of documents can run into tens of millions of pages and can take years. Depositions can consume days or even weeks of an executive's time.

Key Takeaway

Many cases never get to trial. They are disposed of by motions to dismiss or are settled after extensive discovery makes clear to the parties the strengths and weaknesses of the parties to the dispute.

Exercises

1. Mrs. Robinson (in the Volkswagen Audi case) never establishes residency in Arizona, returns to New York, and files her case in federal district court in New York, alleging diversity jurisdiction. Assume that the defendants do not want to have the case heard in federal court. What motion will they make?
2. Under contributory negligence, the negligence of any plaintiff that causes or contributes to the injuries a plaintiff complains of will be grounds for dismissal. Suppose that in discovery, Mr. Ferlito in *Ferlito v. Johnson & Johnson* (Section 3.9) admits that he brought the cigarette lighter dangerously close to his costume, saying, "Yes, you could definitely say I was being careless; I had a few drinks under my belt." Also, Mrs. Ferlito admits that she never reads product instructions from manufacturers. If the case is brought in a state where contributory negligence is the law, on what basis can Johnson & Johnson have the case dismissed before trial?

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2.5: The Pretrial and Trial Phase

Learning Objectives

By the end of this section, you will be able to:

- Understand how judges can push parties into pretrial settlement.
- Explain the meaning and use of directed verdicts.
- Distinguish a directed verdict from a judgment n.o.v. (“notwithstanding the verdict”).

After considerable discovery, one of the parties may believe that there is no triable issue of law or fact for the court to consider and may file a motion with the court for summary judgment. Unless it is very clear, the judge will deny a summary judgment motion, because that ends the case at the trial level; it is a “final order” in the case that tells the plaintiff “no” and leaves no room to bring another lawsuit against the defendant for that particular set of facts (res judicata). If the plaintiff successfully appeals a summary judgment motion, the case will come back to the trial court.

Prior to the trial, the judge may also convene the parties in an effort to investigate the possibilities of settlement. Usually, the judge will explore the strengths and weaknesses of each party’s case with the attorneys. The parties may decide that it is more prudent or efficient to settle than to risk going to trial.

Pretrial Conference

At various times during the discovery process, depending on the nature and complexity of the case, the court may hold a pretrial conference to clarify the issues and establish a timetable. The court may also hold a settlement conference to see if the parties can work out their differences and avoid trial altogether. Once discovery is complete, the case moves on to trial if it has not been settled. Most cases are settled before this stage; perhaps 85 percent of all civil cases end before trial, and more than 90 percent of criminal prosecutions end with a guilty plea.

Trial

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 US 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, especially in high-profile cases. 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. For example, in the Robinsons’ 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 similar problem (or worse) 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, at her discretion, could 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 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.

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 her 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.

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.

After direct testimony of each witness is over, 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 must respond to questions that are at all relevant to the questions raised by 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 re-cross-examination, and so on. The process usually stops after cross-examination or redirect.

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. 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 her case, she may preserve an objection to the court's ruling by saying "exception," in which case the court stenographer will note the exception; on appeal, the attorney may cite any number of exceptions as adding up to the lack of a fair trial for her client and may request a court of appeals to order a retrial.

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.

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 argue with the evidence the defendant has introduced. The defendant in turn may present "surrebuttal" 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. (For example, the plaintiff alleges that the defendant owes him money and introduces a signed promissory note. 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.

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.

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 the case will have 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.)

Posttrial Motions

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*). A judge who decides that a directed verdict is appropriate will usually wait to see what the jury's verdict is. If it is favorable to the party the judge thinks should win, she can rely on that verdict. If the verdict is for the other party, he can grant the motion for judgment n.o.v. This is a safer way to proceed because if the judge is reversed on appeal, a new trial is not necessary. The jury's verdict always can be restored, whereas without a jury verdict (as happens when a directed verdict is granted before the case goes to the jury), the entire case must be presented to a new jury. *Ferlito v. Johnson & Johnson* (Section 3.9) illustrates the judgment n.o.v. process in a case where the judge allowed the case to go to a jury that was overly sympathetic to the plaintiffs.

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

Rule 50(b) says,

Whenever a motion for a directed verdict made at the close of all the evidence is denied or for any reason is not granted, the court is deemed to have submitted the action to the jury subject to a later determination of the legal questions raised by the motion. Not later than 10 days after entry of judgment, a party who has moved for a directed verdict may move to have the verdict and any judgment entered thereon set aside and to have judgment entered in accordance with the party's motion for a directed verdict.…[A] new trial may be prayed for in the alternative. If a verdict was returned the court may allow the judgment to stand or may reopen the judgment and either order a new trial or direct the entry of judgment as if the requested verdict had been directed.

Key Takeaway

The purpose 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 what. 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 are prejudicial, as opposed to harmless. The appeals court must decide whether any errors of the trial court judge are prejudicial or not.

If a judge directs a verdict, that ends the case for the party who hasn't asked for one; if a judge grants judgment n.o.v., that will take away a jury verdict that one side has worked very hard to get. Thus a judge must be careful not to unduly favor one side or the other, regardless of his or her sympathies.

Exercises

1. What if there was not a doctrine of res judicata? What would the legal system be like?
2. Why do you think cross-examination is a "right," as opposed to a "good thing"? What kind of judicial system would not allow cross-examination of witnesses as a matter of right?

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2.6: Judgment, Appeal, and Execution

Learning Objectives

By the end of this section, you will be able to:

- Understand the posttrial process—how appellate courts process appeals.
- Explain how a court's judgment is translated into relief for the winning party.

Judgment or Order

At the end of a trial, the judge will enter an order that makes findings of fact (often with the help of a jury) and conclusions of law. The judge will also make a judgment as to what relief or remedy should be given. Often it is an award of money damages to one of the parties. The losing party may ask for a new trial at this point or within a short period of time following. Once the trial judge denies any such request, the judgment—in the form of the court's order—is final.

Appeal

If the loser's motion for a new trial or a judgment n.o.v. is denied, the losing party may appeal but must ordinarily post a bond sufficient to ensure that there are funds to pay the amount awarded to the winning party. In an appeal, the appellant aims to show that there was some prejudicial error committed by the trial judge. There will be errors, of course, but the errors must be significant (i.e., not harmless). The basic idea is for an appellate court to ensure that a reasonably fair trial was provided to both sides. Enforcement of the court's judgment—an award of money, an injunction—is usually stayed (postponed) until the appellate court has ruled. As noted earlier, the party making the appeal is called the appellant, and the party defending the judgment is the appellee (or in some courts, the petitioner and the respondent).

During the trial, the losing party may have objected to certain procedural decisions by the judge. In compiling a record on appeal, the appellant needs to show the appellate court some examples of mistakes made by the judge—for example, having erroneously admitted evidence, having failed to admit proper evidence that should have been admitted, or having wrongly instructed the jury. The appellate court must determine if those mistakes were serious enough to amount to prejudicial error.

Appellate and trial procedures are different. The appellate court does not hear witnesses or accept evidence. It reviews the *record* of the case—the transcript of the witnesses' testimony and the documents received into evidence at trial—to try to find a legal error on a specific request of one or both of the parties. The parties' lawyers prepare briefs (written statements containing the facts in the case), the procedural steps taken, and the argument or discussion of the meaning of the law and how it applies to the facts. After reading the briefs on appeal, the appellate court may dispose of the appeal without argument, issuing a written opinion that may be very short or many pages. Often, though, the appellate court will hear oral argument. (This can be months, or even more than a year after the briefs are filed.) Each lawyer is given a short period of time, usually no more than thirty minutes, to present his client's case. The lawyer rarely gets a chance for an extended statement because he is usually interrupted by questions from the judges. Through this exchange between judges and lawyers, specific legal positions can be tested and their limits explored.

Depending on what it decides, the appellate court will *affirm* the lower court's judgment, *modify* it, *reverse* it, or *remand* it to the lower court for retrial or other action directed by the higher court. The appellate court itself does not take specific action in the case; it sits only to rule on contested issues of law. The lower court must issue the final judgment in the case. As we have already seen, there is the possibility of appealing from an intermediate appellate court to the state supreme court in twenty-nine states and to the US Supreme Court from a ruling from a federal circuit court of appeal. In cases raising constitutional issues, there is also the possibility of appeal to the Supreme Court from the state courts.

Like trial judges, appellate judges must follow previous decisions, or precedent. But not every previous case is a precedent for every court. Lower courts must respect appellate court decisions, and courts in one state are not bound by decisions of courts in other states. State courts are not bound by decisions of federal courts, except on points of federal law that come from federal courts within the state or from a federal circuit in which the state court sits. A state supreme court is not bound by case law in any other state. But a supreme court in one state with a type of case it has not previously dealt with may find persuasive reasoning in decisions of other state supreme courts.

Federal district courts are bound by the decisions of the court of appeals in their circuit, but decisions by one circuit court are not precedents for courts in other circuits. Federal courts are also bound by decisions of the state supreme courts within their geographic territory in diversity jurisdiction cases. All courts are bound by decisions of the US Supreme Court, except the Supreme Court itself, which seldom reverses itself but on occasion has overturned its own precedents.

Not everything a court says in an opinion is a precedent. Strictly speaking, only the exact holding is binding on the lower courts. A holding is the theory of the law that applies to the particular circumstances presented in a case. The courts may sometimes declare what they believe to be the law with regard to points that are not central to the case being decided. These declarations are called dicta (the singular, *dictum*), and the lower courts do not have to give them the same weight as holdings.

Judgment and Order

When a party has no more possible appeals, it usually pays up voluntarily. If not voluntarily, then the losing party's assets can be seized or its wages or other income garnished to satisfy the judgment. If the final judgment is an injunction, failure to follow its dictates can lead to a contempt citation, with a fine or jail time imposed.

Key Takeaway

The process of conducting a civil trial has many aspects, starting with pleadings and continuing with motions, discovery, more motions, pretrial conferences, and finally the trial itself. At all stages, the rules of civil procedure attempt to give both sides plenty of notice, opportunity to be heard, discovery of relevant information, cross-examination, and the preservation of procedural objections for purposes of appeal. All of these rules and procedures are intended to provide each side with a fair trial.

Exercises

1. Mrs. Robinson has a key witness on auto safety that the judge believes is not qualified as an expert. The judge examines the witness while the jury is in the jury room and disqualifies him from testifying. The jury does not get to hear this witness. Her attorney objects. She loses her case. What argument would you expect Mrs. Robinson's attorney to make in an appeal?
2. Why don't appellate courts need a witness box for witnesses to give testimony under oath?
3. A trial judge in Nevada is wondering whether to enforce a surrogate motherhood contract. Penelope Barr, of Reno, Nevada, has contracted with Reuben and Tina Goldberg to bear the in vitro fertilized egg of Mrs. Goldberg. After carrying the child for nine months, Penelope gives birth, but she is reluctant to give up the child, even though she was paid $20,000 at the start of the contract and will earn an additional $20,000 on handing over the baby to the Goldbergs. (Barr was an especially good candidate for surrogate motherhood: she had borne two perfect children and at age 28 drinks no wine, does not smoke or use drugs of any kind, practices yoga, and maintains a largely vegetarian diet with just enough meat to meet the needs of the fetus within.)The Goldbergs have asked the judge for an order compelling Penelope to give up the baby, who was five days old when the lawsuit was filed. The baby is now a month old as the judge looks in vain for guidance from any Nevada statute, federal statute, or any prior case in Nevada that addressed the issue of surrogate motherhood. He does find several well-reasoned cases, one from New Jersey, one from Michigan, and one from Oregon. Are any of these "precedent" that he must follow? May he adopt the reasoning of any of these courts, if he should find that reasoning persuasive?

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2.7: When Can Someone Bring a Lawsuit?

Learning Objectives

By the end of this section, you will be able to:

- Explain the requirements for standing to bring a lawsuit in US courts.
- Describe the process by which a group or class of plaintiffs can be certified to file a class action case.

Almost anyone can bring a lawsuit, assuming they have the filing fee and the help of an attorney. But the court may not hear it, for a number of reasons. There may be no case or controversy, there may be no law to support the plaintiff's claim, it may be in the wrong court, too much time might have lapsed (a statute of limitations problem), or the plaintiff may not have standing.

Case or Controversy: Standing to Sue

Article III of the US Constitution provides limits to federal judicial power. For some cases, the Supreme Court has decided that it has no power to adjudicate because there is no "case or controversy." For example, perhaps the case has settled or the "real parties in interest" are not before the court. In such a case, a court might dismiss the case on the grounds that the plaintiff does not have "standing" to sue.

For example, suppose you see a sixteen-wheel moving van drive across your neighbor's flower bed, destroying her beloved roses. You have enjoyed seeing her roses every summer, for years. She is forlorn and tells you that she is not going to raise roses there anymore. She also tells you that she has decided not to sue, because she has made the decision to never deal with lawyers if at all possible. Incensed, you decide to sue on her behalf. But you will not have standing to sue because your person or property was not directly injured by the moving van. Standing means that only the person whose interests are directly affected has the legal right to sue.

The standing doctrine is easy to understand in straightforward cases such as this but is often a fairly complicated matter. For example, can fifteen or more state attorneys general bring a lawsuit for a declaratory judgment that the health care legislation passed in 2010 is unconstitutional? What particular injury have they (or the states) suffered? Are they the best set of plaintiffs to raise this issue? Time—and the Supreme Court—will tell.

Class Actions

Most lawsuits concern a dispute between two people or between a person and a company or other organization. But it can happen that someone injures more than one person at the same time. A driver who runs a red light may hit another car carrying one person or many people. If several people are injured in the same accident, they each have the right to sue the driver for the damage that he caused them. Could they sue as a group? Usually not, because the damages would probably not be the same for each person, and different facts would have to be proved at the trial. Plus, the driver of the car that was struck might have been partially to blame, so the defendant's liability toward him might be different from his liability toward the passengers.

If, however, the potential plaintiffs were all injured in the same way and their injuries were identical, a single lawsuit might be a far more efficient way of determining liability and deciding financial responsibility than many individual lawsuits.

How could such a suit be brought? All the injured parties could hire the same lawyer, and she could present a common case. But with a group numbering more than a handful of people, it could become overwhelmingly complicated. So how could, say, a million stockholders who believed they were cheated by a corporation ever get together to sue?

Because of these types of situations, there is a legal procedure that permits one person or a small group of people to serve as representatives for all others. This is the class action. The class action is provided for in the Federal Rules of Civil Procedure (Rule 23) and in the separate codes of civil procedure in the states. These rules differ among themselves and are often complex, but in general anyone can file a class action in an appropriate case, subject to approval of the court. Once the class is "certified," or judged to be a legally adequate group with common injuries, the lawyers for the named plaintiffs become, in effect, lawyers for the entire class.

Usually a person who doesn't want to be in the class can decide to leave. If she does, she will not be included in an eventual judgment or settlement. But a potential plaintiff who is included in the class cannot, after a final judgment is awarded, seek to relitigate the issue if she is dissatisfied with the outcome, even though she did not participate at all in the legal proceeding.

Key Takeaway

Anyone can file a lawsuit, with or without the help of an attorney, but only those lawsuits where a plaintiff has standing will be heard by the courts. Standing has become a complicated question and is used by the courts to ensure that civil cases heard are being pursued by those with tangible and particular injuries. Class actions are a way of aggregating claims that are substantially similar and arise out of the same facts and circumstances.

Exercises

1. Fuchs Funeral Home is carrying the body of Charles Emmenthaler to its resting place at Forest Lawn Cemetery. Charles's wife, Chloe, and their two children, Chucky and Clarice, are following the hearse when the coffin falls on the street, opens, and the body of Charles Emmenthaler falls out. The wife and children are shocked and aggrieved and later sue in civil court for damages. Assume that this is a viable cause of action based on "negligent infliction of emotional distress" in the state of California and that Charles's brother, sister-in-law, and multiple cousins also were in the funeral procession and saw what happened. The brother of Charles, Kingston Emmenthaler, also sees his brother's body on the street, but his wife, their three children, and some of Charles's other cousins do not.Charles was actually emotionally closest to Kingston's oldest son, Nestor, who was studying abroad at the time of the funeral and could not make it back in time. He is as emotionally distraught at his uncle's passing as anyone else in the family and is especially grieved over the description of the incident and the grainy video shot by one of the cousins on his cell phone. Who has standing to sue Fuchs Funeral Home, and who does not?

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2.8: Relations with Lawyers

Learning Objectives

By the end of this section, you will be able to:

- Understand the various ways that lawyers charge for services.
- Describe the contingent fee system in the United States.
- Know the difference between the American rule and the British rule with regard to who pays attorneys' fees.

Legal Fees

Lawyers charge for their services in one of three different ways: flat rate, hourly rate, and contingent fee. A flat rate is used usually when the work is relatively routine and the lawyer knows in advance approximately how long it will take her to do the job. Drawing a will or doing a real estate closing are examples of legal work that is often paid a flat rate. The rate itself may be based on a percentage of the worth of the matter—say, 1 percent of a home's selling price.

Lawyers generally charge by the hour for courtroom time and for ongoing representation in commercial matters. Virtually every sizable law firm bills its clients by hourly rates, which in large cities can range from $300 for an associate's time to $500 and more for a senior partner's time.

A contingent fee is one that is paid only if the lawyer wins—that is, it is contingent, or depends upon, the success of the case. This type of fee arrangement is used most often in personal injury cases (e.g., automobile accidents, products liability, and professional malpractice). Although used quite often, the contingent fee is controversial. Trial lawyers justify it by pointing to the high cost of preparing for such lawsuits. A typical automobile accident case can cost at least ten thousand dollars to prepare, and a complicated products-liability case can cost tens of thousands of dollars. Few people have that kind of money or would be willing to spend it on the chance that they might win a lawsuit. Corporate and professional defendants complain that the contingent fee gives lawyers a license to go big game hunting, or to file suits against those with deep pockets in the hopes of forcing them to settle.

Trial lawyers respond that the contingent fee arrangement forces them to screen cases and weed out cases that are weak, because it is not worth their time to spend the hundreds of hours necessary on such cases if their chances of winning are slim or nonexistent.

Costs

In England and in many other countries, the losing party must pay the legal expenses of the winning party, including attorneys' fees. That is not the general rule in this country. Here, each party must pay most of its own costs, including (and especially) the fees of lawyers. (Certain relatively minor costs, such as filing fees for various documents required in court, are chargeable to the losing side, if the judge decides it.) This type of fee structure is known as the American rule (in contrast to the British rule).

There are two types of exceptions to the American rule. By statute, Congress and the state legislatures have provided that the winning party in particular classes of cases may recover its full legal costs from the loser—for example, the federal antitrust laws so provide and so does the federal Equal Access to Justice Act. The other exception applies to litigants who either initiate lawsuits in bad faith, with no expectation of winning, or who defend them in bad faith, in order to cause the plaintiff great expense. Under these circumstances, a court has the discretion to award attorneys' fees to the winner. But this rule is not infinitely flexible, and courts do not have complete freedom to award attorneys' fees in any amount, but only "reasonable" attorney's fees.

Key Takeaway

Litigation is expensive. Getting a lawyer can be costly, unless you get a lawyer on a contingent fee. Not all legal systems allow contingent fees. In many legal systems, the loser pays attorneys' fees for both parties.

Exercises

1. Mrs. Robinson's attorney estimates that they will recover a million dollars from Volkswagen in the Audi lawsuit. She has Mrs. Robinson sign a contract that gives her firm one-third of any recovery after the firm's expenses are deducted. The judge does in fact award a million dollars, and the defendant pays. The firm's expenses are $100,000. How much does Mrs. Robinson get?

2. Harry Potter brings a lawsuit against Draco Malfoy in Chestershire, England, for slander, a form of defamation. Potter alleges that Malfoy insists on calling him a mudblood. Ron Weasley testifies, as does Neville Longbottom. But Harry loses, because the court has no conception of wizardry and cannot make sense of the case at all. In dismissing the case, however, who (under English law) will bear the costs of the attorneys who have brought the case for Potter and defended the matter for Malfoy?

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2.9: Alternative Means of Resolving Disputes

Learning Objectives

By the end of this section, you will be able to:

- Understand how arbitration and mediation are frequently used alternatives to litigation.
- Describe the differences between arbitration and mediation.
- Explain why arbitration is final and binding.

Disputes do not have to be settled in court. No law requires parties who have a legal dispute to seek judicial resolution if they can resolve their disagreement privately or through some other public forum. In fact, the threat of a lawsuit can frequently motivate parties toward private negotiation. Filing a lawsuit may convince one party that the other party is serious. Or the parties may decide that they will come to terms privately rather than wait the three or four years it can frequently take for a case to move up on the court calendar.

Arbitration

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 litigants and potential litigants to settle certain types of quarrels than through the courts. As a result, neighborhood justice centers or dispute resolution centers have sprung up in communities. These are where people can come for help in settling disputes, of both civil and criminal nature, that should not consume the time and money of the parties or courts in lengthy proceedings.

These alternative forums use a variety of methods, including arbitration, mediation, and conciliation, to bring about agreement or at least closure of the dispute. These methods are not all alike, and their differences are worth noting.

Arbitration is a type of adjudication. 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 predispute arbitration agreement (often part of a larger contract), the parties can spell out the rules of procedure to be used and the method for choosing the arbitrator. For example, they 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.

Many arbitrations take place under the auspices of the American Arbitration Association, a private organization headquartered in New York, with regional offices in many other cities. The association uses published sets of rules for various types of arbitration (e.g., labor arbitration or commercial arbitration); parties who provide in contracts for arbitration through the association are agreeing to be bound by the association's rules. Similarly, the National Association of Securities Dealers provides arbitration services for disputes between clients and brokerage firms. International commercial arbitration often takes place through the auspices of the International Chamber of Commerce. A multilateral agreement known as the Convention on the Recognition and Enforcement of Arbitral Awards provides that agreements to arbitrate—and arbitral awards—will be enforced across national boundaries.

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.

Under both federal and state law, arbitration is favored, and a decision rendered by an arbitrator is binding by law and may be enforced by the courts. The arbitrator's decision is final and binding, with very few exceptions (such as fraud or manifest disregard of the law by the arbitrator or panel of arbitrators). Saying that arbitration is favored means 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.

Mediation

Unlike adjudication, 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, go to court, or forget the whole thing!

Key Takeaway

Litigation is not the only way to resolve disputes. Informal negotiation between the disputants usually comes first, but both mediation and arbitration are available. Arbitration, though, 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.

Exercises

1. When Mrs. Robinson buys her Audi from Seaway, there is a paragraph in the bill of sale, which both the dealer and Mrs. Robinson sign, that says, "In the event of any complaint by customer/buyer against Seaway regarding the vehicle purchased herein, such complaint shall not be litigated, but may only be arbitrated under the rules of the American Arbitration Association and in accordance with New York law." Mrs. Robinson did not see the provision, doesn't like it, and wants to bring a lawsuit in Oklahoma against Seaway. What is the result?
2. Hendrik Koster (Netherlands) contracts with Automark, Inc. (a US company based in Illinois) to supply Automark with a large quantity of valve cap gauges. He does, and Automark fails to pay. Koster thinks he is owed $66,000. There is no agreement to arbitrate or mediate. Can Koster make Automark mediate or arbitrate?
3. Suppose that there is an agreement between Koster and Automark to arbitrate. It says, "The parties agree to arbitrate any dispute arising under this agreement in accordance with the laws of the Netherlands and under the auspices of the International Chamber of Commerce's arbitration facility." The International Chamber of Commerce has arbitration rules and will appoint an arbitrator or arbitral panel in the event the parties cannot agree on an arbitrator. The arbitration takes place in Geneva. Koster gets an arbitral award for $66,000 plus interest. Automark does not participate in any way. Will a court in Illinois enforce the arbitral award?

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2.10: Cases

Burger King v. Rudzewicz

Burger King Corp. v. Rudzewicz

471 U.S. 462 (U.S. Supreme Court 1985)

Summary

Burger King Corp. is a Florida corporation with principal offices in Miami. It principally conducts restaurant business through franchisees. The franchisees are licensed to use Burger King's trademarks and service marks in standardized restaurant facilities. Rudzewicz is a Michigan resident who, with a partner (MacShara) operated a Burger King franchise in Drayton Plains, Michigan. Negotiations for setting up the franchise occurred in 1978 largely between Rudzewicz, his partner, and a regional office of Burger King in Birmingham, Michigan, although some deals and concessions were made by Burger King in Florida. A preliminary agreement was signed in February of 1979. Rudzewicz and MacShara assumed operation of an existing facility in Drayton Plains and MacShara attended prescribed management courses in Miami during the four months following Feb. 1979.

Rudzewicz and MacShara bought $165,000 worth of restaurant equipment from Burger King's Davmor Industries division in Miami. But before the final agreements were signed, the parties began to disagree over site-development fees, building design, computation of monthly rent, and whether Rudzewicz and MacShara could assign their liabilities to a corporation they had formed. Negotiations took place between Rudzewicz, MacShara, and the Birmingham regional office; but Rudzewicz and MacShara learned that the regional office had limited decision-making power and turned directly to Miami headquarters for their concerns. The final agreement was signed by June 1979 and provided that the franchise relationship was governed by Florida law, and called for payment of all required fees and forwarding of all relevant notices to Miami headquarters.

The Drayton Plains restaurant did fairly well at first, but a recession in late 1979 caused the franchisees to fall far behind in their monthly payments to Miami. Notice of default was sent from Miami to Rudzewicz, who nevertheless continued to operate the restaurant as a Burger King franchise. Burger King sued in federal district court for the southern district of Florida. Rudzewicz contested the court's personal jurisdiction over him, since he had never been to Florida.

The federal court looked to Florida's long arm statute and held that it did have personal jurisdiction over the non-resident franchisees, and awarded Burger King a quarter of a million dollars in contract damages and enjoined the franchisees from further operation of the Drayton Plains facility. Franchisees appealed to the 11th Circuit Court of Appeals and won a reversal based on lack of personal jurisdiction. Burger King petitioned the Supreme Ct. for a *writ of certiorari*.

Justice Brennan delivered the opinion of the court.

The Due Process Clause protects an individual's liberty interest in not being subject to the binding judgments of a forum with which he has established no meaningful "contacts, ties, or relations." International Shoe Co. v. Washington. By requiring that individuals have "fair warning that a particular activity may subject [them] to the jurisdiction of a foreign sovereign," the Due Process Clause "gives a degree of predictability to the legal system that allows potential defendants to structure their primary conduct with some minimum assurance as to where that conduct will and will not render them liable to suit."…

Where a forum seeks to assert specific jurisdiction over an out-of-state defendant who has not consented to suit there, this "fair warning" requirement is satisfied if the defendant has "purposefully directed" his activities at residents of the forum, and the litigation results from alleged injuries that "arise out of or relate to" those activities, Thus "[t]he forum State does not exceed its powers under the Due Process Clause if it asserts personal jurisdiction over a corporation that delivers its products into the stream of commerce with the expectation that they will be purchased by consumers in the forum State" and those products subsequently injure forum consumers. Similarly, a publisher who distributes magazines in a distant State may fairly be held accountable in that forum for damages resulting there from an allegedly defamatory story.…

…[T]he constitutional touchstone remains whether the defendant purposefully established "minimum contacts" in the forum State.…In defining when it is that a potential defendant should "reasonably anticipate" out-of-state litigation, the Court frequently has drawn from the reasoning of Hanson v. Denckla, 357 U.S. 235, 253 (1958):

The unilateral activity of those who claim some relationship with a nonresident defendant cannot satisfy the requirement of contact with the forum State. The application of that rule will vary with the quality and nature of the defendant's activity, but it is essential in each case that there be some act by which the defendant purposefully avails itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws.

This "purposeful availment" requirement ensures that a defendant will not be haled into a jurisdiction solely as a result of "random," "fortuitous," or "attenuated" contacts, or of the "unilateral activity of another party or a third person," [Citations] Jurisdiction is proper, however, where the contacts proximately result from actions by the defendant himself that create a "substantial connection" with the forum State. [Citations] Thus where the defendant "deliberately" has engaged in significant activities within a State, or has created "continuing obligations" between himself and residents of the forum, he manifestly has availed himself of the privilege of conducting business there, and because his activities are shielded by "the benefits and protections" of the forum's laws it is presumptively not unreasonable to require him to submit to the burdens of litigation in that forum as well.

Jurisdiction in these circumstances may not be avoided merely because the defendant did not physically enter the forum State. Although territorial presence frequently will enhance a potential defendant's affiliation with a State and reinforce the reasonable foreseeability of suit there, it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State in which business is conducted. So long as a commercial actor's efforts are "purposefully directed" toward residents of another State, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there.

Once it has been decided that a defendant purposefully established minimum contacts within the forum State, these contacts may be considered in light of other factors to determine whether the assertion of personal jurisdiction would comport with "fair play and substantial justice." " target="_blank">International Shoe Co. v. Washington, 326 U.S., at 320. Thus courts in "appropriate case[s]" may evaluate "the burden on the defendant," "the forum State's interest in adjudicating the dispute," "the plaintiff's interest in obtaining convenient and effective relief," "the interstate judicial system's interest in obtaining the most efficient resolution of controversies," and the "shared interest of the several States in furthering fundamental substantive social policies." These considerations sometimes serve to establish the reasonableness of jurisdiction upon a lesser showing of minimum contacts than would otherwise be required. [Citations] Applying these principles to the case at hand, we believe there is substantial record evidence supporting the District Court's conclusion that the assertion of personal jurisdiction over Rudzewicz in Florida for the alleged breach of his franchise agreement did not offend due process.…

In this case, no physical ties to Florida can be attributed to Rudzewicz other than MacShara's brief training course in Miami. Rudzewicz did not maintain offices in Florida and, for all that appears from the record, has never even visited there. Yet this franchise dispute grew directly out of "a contract which had a substantial connection with that State." Eschewing the option of operating an independent local enterprise, Rudzewicz deliberately "reach[ed] out beyond" Michigan and negotiated with a Florida corporation for the purchase of a long-term franchise and the manifold benefits that would derive from affiliation with a nationwide organization. Upon approval, he entered into a carefully structured 20-year relationship that envisioned continuing and wide-reaching contacts with Burger King in Florida. In light of Rudzewicz' voluntary acceptance of the long-term and exacting regulation of his business from Burger King's Miami headquarters, the "quality and nature" of his relationship to the company in Florida can in no sense be viewed as "random," "fortuitous," or "attenuated." Rudzewicz' refusal to make the contractually required payments in Miami, and his continued use of Burger King's trademarks and confidential business information after his termination, caused foreseeable injuries to the corporation in Florida. For these reasons it was, at the very least, presumptively reasonable for Rudzewicz to be called to account there for such injuries.

…Because Rudzewicz established a substantial and continuing relationship with Burger King's Miami headquarters, received fair notice from the contract documents and the course of dealing that he might be subject to suit in Florida, and has failed to demonstrate how jurisdiction in that forum would otherwise be fundamentally unfair, we conclude that the District Court's exercise of jurisdiction pursuant to Fla. Stat. 48.193(1)(g) (Supp. 1984) did not offend due process. The judgment of the Court of Appeals is accordingly reversed, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

? Case Questions

1. Why did Burger King sue in Florida rather than in Michigan?
2. If Florida has a long-arm statute that tells Florida courts that it may exercise personal jurisdiction over someone like Rudzewicz, why is the court talking about the due process clause?
3. Why is this case in federal court rather than in a Florida state court?
4. If this case had been filed in state court in Florida, would Rudzewicz be required to come to Florida? Explain.

Ferlito v. Johnson & Johnson

Ferlito v. Johnson & Johnson Products, Inc.

771 F. Supp. 196 (U.S. District Ct., Eastern District of Michigan 1991)

Gadola, J.

Plaintiffs Susan and Frank Ferlito, husband and wife, attended a Halloween party in 1984 dressed as Mary (Mrs. Ferlito) and her little lamb (Mr. Ferlito). Mrs. Ferlito had constructed a lamb costume for her husband by gluing cotton batting manufactured by defendant Johnson & Johnson Products ("JJP") to a suit of long underwear. She had also used defendant's product to fashion a headpiece, complete with ears. The costume covered Mr. Ferlito from his head to his ankles, except for his face and hands, which were blackened with Halloween paint. At the party Mr. Ferlito attempted to light his cigarette by using a butane lighter. The flame passed close to his left arm, and the cotton batting on his left sleeve ignited. Plaintiffs sued defendant for injuries they suffered from burns which covered approximately one-third of Mr. Ferlito's body.

Following a jury verdict entered for plaintiffs November 2, 1989, the Honorable Ralph M. Freeman entered a judgment for plaintiff Frank Ferlito in the amount of $555,000 and for plaintiff Susan Ferlito in the amount of $ 70,000. Judgment was entered November 7, 1989. Subsequently, on November 16, 1989, defendant JJP filed a timely motion for judgment notwithstanding the verdict pursuant to Fed.R.Civ.P. 50(b) or, in the alternative, for new trial. Plaintiffs filed their response to defendant's motion December 18, 1989; and defendant filed a reply January 4, 1990. Before reaching a decision on this motion, Judge Freeman died. The case was reassigned to this court April 12, 1990.

MOTION FOR JUDGMENT NOTWITHSTANDING THE VERDICT

Defendant JJP filed two motions for a directed verdict, the first on October 27, 1989, at the close of plaintiffs' proofs, and the second on October 30, 1989, at the close of defendant's proofs. Judge Freeman denied both motions without prejudice. Judgment for plaintiffs was entered November 7, 1989; and defendant's instant motion, filed November 16, 1989, was filed in a timely manner.

The standard for determining whether to grant a j.n.o.v. is identical to the standard for evaluating a motion for directed verdict:

In determining whether the evidence is sufficient, the trial court may neither weigh the evidence, pass on the credibility of witnesses nor substitute its judgment for that of the jury. Rather, the evidence must be viewed in the light most favorable to the party against whom the motion is made, drawing from that evidence all reasonable inferences in his favor. If after reviewing the evidence…the trial court is of the opinion that reasonable minds could not come to the result reached by the jury, then the motion for j.n.o.v. should be granted.

To recover in a "failure to warn" product liability action, a plaintiff must prove each of the following four elements of negligence: (1) that the defendant owed a duty to the plaintiff, (2) that the defendant violated that duty, (3) that the defendant's breach of that duty was a proximate cause of the damages suffered by the plaintiff, and (4) that the plaintiff suffered damages.

To establish a *prima facie case* that a manufacturer's breach of its duty to warn was a proximate cause of an injury sustained, a plaintiff must present evidence that the product would have been used differently had the proffered warnings been given.By "prima facie case," the court means a case in which the plaintiff has presented all the basic elements of the cause of action alleged in the complaint. If one or more elements of proof are missing, then the plaintiff has fallen short of establishing a prima facie case, and the case should be dismissed (usually on the basis of a directed verdict). [Citations omitted] In the absence of evidence that a warning would have prevented the harm complained of by altering the plaintiff's conduct, the failure to warn cannot be deemed a

proximate cause of the plaintiff's injury as a matter of law. [In accordance with procedure in a diversity of citizenship case, such as this one, the court cites Michigan case law as the basis for its legal interpretation.]

…

A manufacturer has a duty "to warn the purchasers or users of its product about dangers associated with intended use." Conversely, a manufacturer has no duty to warn of a danger arising from an unforeseeable misuse of its product. [Citation] Thus, whether a manufacturer has a duty to warn depends on whether the use of the product and the injury sustained by it are foreseeable. Gootee v. Colt Industries Inc., 712 F.2d 1057, 1065 (6th Cir. 1983); Owens v. Allis-Chalmers Corp., 414 Mich. 413, 425, 326 N.W.2d 372 (1982). Whether a plaintiff's use of a product is foreseeable is a legal question to be resolved by the court. Trotter, *supra*. Whether the resulting injury is foreseeable is a question of fact for the jury.Note the division of labor here: questions of law are for the judge, while questions of "fact" are for the jury. Here, "foreseeability" is a fact question, while the judge retains authority over questions of law. The division between questions of fact and questions of law is not an easy one, however. Thomas v. International Harvester Co., 57 Mich. App. 79, 225 N.W.2d 175 (1974).

In the instant action no reasonable jury could find that JJP's failure to warn of the flammability of cotton batting was a proximate cause of plaintiffs' injuries because plaintiffs failed to offer any evidence to establish that a flammability warning on JJP's cotton batting would have dissuaded them from using the product in the manner that they did.

Plaintiffs repeatedly stated in their response brief that plaintiff Susan Ferlito testified that "she would never again use cotton batting to make a costume…However, a review of the trial transcript reveals that plaintiff Susan Ferlito never testified that she would never again use cotton batting to make a costume. More importantly, the transcript contains no statement by plaintiff Susan Ferlito that a flammability warning on defendant JJP's product would have dissuaded her from using the cotton batting to construct the costume in the first place. At oral argument counsel for plaintiffs conceded that there was no testimony during the trial that either plaintiff Susan Ferlito or her husband, plaintiff Frank J. Ferlito, would have acted any different if there had been a flammability warning on the product's package. The absence of such testimony is fatal to plaintiffs' case; for without it, plaintiffs have failed to prove proximate cause, one of the essential elements of their negligence claim.

In addition, both plaintiffs testified that they knew that cotton batting burns when it is exposed to flame. Susan Ferlito testified that she knew at the time she purchased the cotton batting that it would burn if exposed to an open flame. Frank Ferlito testified that he knew at the time he appeared at the Halloween party that cotton batting would burn if exposed to an open flame. His additional testimony that he would not have intentionally put a flame to the cotton batting shows that he recognized the risk of injury of which he claims JJP should have warned. Because both plaintiffs were already aware of the danger, a warning by JJP would have been superfluous. Therefore, a reasonable jury could not have found that JJP's failure to provide a warning was a proximate cause of plaintiffs' injuries.

The evidence in this case clearly demonstrated that neither the use to which plaintiffs put JJP's product nor the injuries arising from that use were foreseeable. Susan Ferlito testified that the idea for the costume was hers alone. As described on the product's package, its intended uses are for cleansing, applying medications, and infant care. Plaintiffs' showing that the product may be used on occasion in classrooms for decorative purposes failed to demonstrate the foreseeability of an adult male encapsulating himself from head to toe in cotton batting and then lighting up a cigarette.

ORDER

NOW, THEREFORE, IT IS HEREBY ORDERED that defendant JJP's motion for judgment notwithstanding the verdict is GRANTED.

IT IS FURTHER ORDERED that the judgment entered November 2, 1989, is SET ASIDE.

IT IS FURTHER ORDERED that the clerk will enter a judgment in favor of the defendant JJP.

? Case Questions

1. The opinion focuses on proximate cause. As we will see in Chapter 7, a negligence case cannot be won unless the plaintiff shows that the defendant has breached a duty and that the defendant's breach has actually and proximately caused the damage complained of. What, exactly, is the alleged breach of duty by the defendant here?

2. Explain why Judge Gadola reasoning that JJP had no duty to warn in this case. After this case, would they then have a duty to warn, knowing that someone might use their product in this way?

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CHAPTER OVERVIEW

3: Business Ethics and Social Responsibility

3.1: Introduction
3.2: Business Ethics
3.3: Social Responsibility
3.4: End Notes
3.E: Assessment Questions

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3.1: Introduction

Learning Objectives

- Analyze the role of ethics and social responsibility in business.



Figure 3.1.1: Introduction (Credit: rawpixel/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

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3.2: Business Ethics

Businesses must establish a clear set of values that promote ethical practices and social responsibility. In today's business climate, companies are increasingly under scrutiny by private citizens. A company that builds its foundation on sound principles will have a better chance of staying competitive in a volatile market.



Figure 3.2.1: A group of employees who uphold strong corporate values can be an asset to the company they work for. (Credit: rawpixel/ pexels/ License: CC0)

Business ethics are considered to be the blueprint for building a successful organization. If an organization is built on socially responsible values, it will be stronger than an organization that is built on profit alone. More than just a positive reputation, the core ethics of a business dictate how every decision, process, and procedure will take place. This steadfast governance applies even if the business faces hard times or difficult situations. Some will even argue that businesses require full transparency in today's world.

Over the last few decades, numerous cases of bad business practices have made headlines. From McDonalds' funding of President Nixon's campaign in an effort to reduce workers' wages in the 1970s, to the more recent case of Uber employees alleging sexual harassment and the company's CEO having a public meltdown in the back of a driver's car, there's no shortage of ethics-related problems in the business world. Businesses are more than people working together to offer a product or service. Businesses are often viewed as entities that should protect stakeholders from unethical behaviors and activities. A set of governing rules should be in place to set the bar high for ethical compliance in every organization.

Why Is Corporate Ethics So Important in Business?

The idea of business ethics may seem subjective, but it comes down to acceptable levels of behavior for each individual who makes up the organization. This behavior must start at the top with responsible actions demonstrated by leadership. By doing so, leaders create a set of rules that are to be followed by others in the company. These rules can be based on the deep values that the company has concerning the quality of products and services, the commitment to customers, or how the organization gives something back to the community. The more a company lives by its set of ethics, the more likely it is to be successful.

Anna Spooner, who writes for LovetoKnow, shares tips on how to evaluate whether or not an organization is creating ethical practices by determining the impact of each practice. Some examples include:

Executive compensation rates during employee layoffs. Let's say a company is struggling during an economic downturn and must lay off a portion of its workforce. Does the CEO of the company take his or her annual raise or take a pay cut when others are

losing their jobs? One could say that to take a raise is unethical because the CEO should also sacrifice some pay for the good of the company.

Fair compensation for employees. Paying employees minimum wage, or just above minimum wage, is not always fair compensation. In most regions, the cost of living has not been adjusted in years, meaning that people are surviving on less money. Ethics can make a difference here.

Ethical business practices, guided by a corporate set of standards, can have many positive outcomes, including recruitment and retention improvement, better relationships with customers, and positive PR. In 2015, Dan Price, CEO of the Seattle payment processing firm Gravity Payments, voluntarily took a huge pay cut and vowed to raise his employees' wages to $70,000. This move was great for the company, which claims that revenues and profits skyrocketed, and they experienced a 91 percent employee retention rate over the last few years.

On the opposite side, unethical business behaviors can have a negative impact on any business. Even if an unethical decision is made by a single member of the executive team, it can have far-reaching repercussions.

Some possible results of unethical business actions may include:

Poor company reputation. In an increasingly transparent world, unethical decisions made by businesspeople become permanent stains on the company. Social networks have become sounding boards for anything deemed unethical or politically incorrect, and everyone from disgruntled employees to dissatisfied customers can rate companies on public company review websites.

Negative employee relations. If employees continually see a discrepancy between what's expected of them and how leadership behaves, this contrast can create serious problems in the management of employees. Some employees may become disengaged, while others will stop working as hard. After all, if the same rules don't apply to everyone, why even bother? The downside to negative employee relations is that the entire company becomes less productive, less responsive to customers, and less profitable.

Recruitment and retention problems. Once a company has developed a negative reputation, it can be difficult to recruit new talent, let alone retain the talent that's already there. Disengaged employees who grow tired of the double standards will leave. This attrition can impact customers who then have to deal with less experienced and less interested employees, who are already overworked and frustrated.

Company credibility lost. Customers are savvy enough to follow what's going on from an ethics standpoint. If they hear of a problem, they begin to question the actions of every person at the company. For example, if a member of the board is accepting expensive gifts from clients in exchange for favorable pricing of materials, this situation could set off major alarms for other customers, and even vendors. The company can expect to lose business if this unethical behavior continues.

As you can see, poor ethics can quickly spiral downward, destroying every aspect of the business and making it very difficult to compete. It's critical for every business to pay attention to ethical standards and continually remind employees at all levels that their behavior has an impact on the entire organization.

History of Corporate Governance

The concept of corporate governance is relatively new compared to the entire history of free trade and business formation. There was likely some "code of honor" followed by businesses in the past, but it wasn't until the 21st century that greater attention was paid to how companies operate and how the operation impacts employees and the communities in which they serve.

According to the Ethics and Compliance Initiative, which is comprised of organizations that are committed to creating best practices in ethics, each decade has been influenced by external factors, such as war or economic turmoil, combined with major ethical focal areas, and the result has been the development of ethics and compliance programs. For example, in the mid-1980s, the United States was thrust into a recessionary period. During this period, government contractors were billing outrageous amounts for equipment and services, further increasing the government's deficit.

At the same time, larger companies began downsizing to cut costs, which eroded the trust that employees once had. People felt the need to look out for themselves. Greed appeared to be everywhere, from political bribes to the earliest financial schemers. As a result, General Dynamics established the first business ethics office in 1985 to crack down on this kind of activity, and other companies created ombudsman positions to help ethics officers identify and prosecute corporate ethics violators.

Ethical Decision-Making Policies

In any organization, sound moral, business, and financial practices must be followed at all times. No one is above the law or has special privileges when it comes to ethics. Decision making needs to happen with corporate governance in mind. According to Michigan State University, the six steps to ethical decision making are:

1. Make sure leaders understand the issue at hand and have gathered all of the facts related to it.
2. Leaders should list all of the facts they know, and list any assumptions they are making about the issue. This step ensures that the leaders keep the facts and assumptions differentiated and in mind.
3. Note all of the concerns related to the issue, including all of the people concerned, the laws related to the issue, and any corporate or professional ethical guidelines that may be involved.
4. Construct a potential solution to the problem.
5. Evaluate the proposed solution, making sure to consider all of the ethical aspects noted in step 3.
6. Once leaders have come to a solution, they recommend it, as well as any actions that need to be taken.

Establishing a Code of Conduct

To educate and guide others in the organization, a set of ethics, or a code of conduct, should be developed and distributed. Kimberlee Leonard, who writes for the Houston Chronicle, states, “A code of ethics is important for businesses to establish to ensure that everyone in the company is clear on the mission, values and guiding principles of the company.” While it takes some time to create a code of conduct, the ideals involved should already be present in the company’s culture.

The elements that belong in a code of conduct, according to Kimberlee Leonard, are:

Legal considerations. The business is a legal entity, and therefore all employees should be thinking about their behavior and how it could easily turn into a lawsuit. Establishing conduct rules at this level can clear up any gray areas. For example, a company should define what sexual harassment is and what to do if an employee experiences it. New items that detail specific codes of conduct can be added as they come up.

Value-based ethics. These are specific ethics that dig under the surface of a corporate culture. A business should think about how it wants to be viewed by the community. Examples could be a commitment to green office practices, reduction of a company’s carbon footprint, giving a certain percentage of a company’s profits to the local food pantry to support the community, etc.

Regulatory ethics. These are designed to maintain certain standards of performance based on the industry. One example is a commitment to maintaining data privacy at all times, as it pertains to customer records. This element defines how employees are to handle sensitive data and what will happen if someone doesn’t follow the rules.

Professional behaviors. One should never assume that just because someone puts on a business suit and goes to work that he or she will behave professionally. Problems such as bullying, harassment, and abuse can happen in the workplace. Establishing behavioral standards for professionalism should include what is acceptable in the office, while traveling, during meetings, and after hours, when colleagues meet with clients and one another.

A good code of conduct is a working document that can be updated and shared as needed. Many companies include this document as part of their employee manual, while others use a secure intranet for displaying this information. No matter where it is housed, employees need to be educated on the code of conduct and refer to it often, starting on the first day on the job.

What to Do When Something Goes Wrong

It should be noted that along with a code of conduct, there needs to be a clear “whistleblower” policy in which violators are identified and action is taken. This process should be handled with complete confidentiality and sensitivity to the company and all parties involved. Retaliation should never be tolerated when it comes to ethics violations. The company should have a step-by-step plan of action for dealing with ethics problems at all levels, up to and including the executive leadership of the company. A third-party investigative firm can be used to handle such matters to remove the burden and influence that internal resources may have.

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3.3: Social Responsibility

Over the last few decades, there has been a movement throughout the global business community to improve the world through smarter use of resources and giving back to communities. This movement is called corporate social responsibility. The concept is catching on at companies that range in size from small startups to large Fortune 500 corporations. In the following section, you will learn what social responsibility is and how it is a win-win for businesses and consumers.



Figure 3.3.1: Employees often like to participate in volunteer activities through their employer. (Credit: rawpixel/ pixabay/ License: CC0)

What Is Corporate Responsibility?

Corporate responsibility refers to the idea that a business is given the opportunity and privilege to make the world a better place. This process can happen through a variety of methods, including the donation of funds, volunteerism, and implementation of environmentally friendly policies. It is up to each organization to determine the best way to demonstrate social responsibility.

While certainly not mandatory, corporate social responsibility has become a popular way for companies to improve their image and promote causes they believe in at the same time. Corporate social responsibility may involve focusing on the immediate community in which a company does business. However, there are some organizations that take it a step further and focus on more widespread global issues. For example, the shoe company TOMS has created a mission to make sure that every boy and girl in underprivileged countries has proper footwear. Blake Mycoskie, CEO of TOMS, has created a complete business model around social responsibility. Not stopping at shoes, the company now also helps with bringing fresh water to communities, as well as making birth safer for babies in developing nations.

The popularity of corporate social responsibility has only increased as millennials and Generation Z employees enter the workforce. Employees in these generations often care deeply about making a difference in the world in which they work. Whether they are buying products from brands that give back or promoting a similar activity in their own place of employment, the youngest of the workforce are making corporate social responsibility a priority.

Where Did the Concept Originate?

Corporate social responsibility is not a new construct. One could go back hundreds of years and find examples of corporate philanthropy and social support. However, the earliest published book about the topic is **Corporate Responsibility of the Businessman**, published in 1953. This book introduced the concept of companies giving back as a form of investment in the future.

This idea came from a generation that had survived some of the hardest times in our world and wanted to make it a better place for generations to come.

By the turn of the millennium, companies were actively participating in a variety of corporate social responsibility projects, from volunteerism to large corporate-matched charitable donations. Nearly every company has some form of charitable campaign, driven by the values of the culture and the interests of employees. Today, some 63 million Americans volunteer each year, which is worth around $175 billion in worker hours annually (Source: Corporation for National and Community Service). On top of volunteering, U.S. corporations give over $18 billion to charities each year through fundraisers and employee-employer matching programs (Source: Giving USA).

How Does Corporate Responsibility Benefit a Business?

There are many ways that corporate social responsibility can benefit a business and its objectives. Aside from being able to promote the causes that are closely connected to the values of the company, a business can improve its reputation exponentially.

Benefits of corporate social responsibility include many direct and indirect effects. Based on research from the Kellogg School of Management at Northwestern University, these can include:

Improved perception by investors. If a company reports corporate social responsibility spending that exceeds the expectations of investors, this dollar amount is a sign that the company itself is in good financial standing. This perception results in positive stock returns and increased confidence by investors.

Enhanced performance for going green. Researchers have found that when companies focus on eco-friendly efforts, the positive impact on operational performance heading into the second year is remarkable. Those that expand their efforts in more complex ways and in collaboration with industry standard-setting associations (such as LEED), or other eco-friendly companies, increase their performance even more.

Contracting for success. In companies that tie their CEO's salary to corporate social responsibility results, also known as contracting, the impact is felt even more. The value of the company increases while the bottom line of the business is maintained.

The benevolent halo effect. When consumers understand the commitment that an organization has to being socially responsible, its image becomes more positive. Customers actually perceive the company and its products in a different way because they expect a better experience.

Consistency of efforts and partnerships. Researchers also found that socially responsible organizations were consistent with staying focused on the issues that mattered most to their employees and customers. A higher level of consistency of efforts prompted better results.

There are some other benefits of being a socially responsible company. These may happen as a result of internal factors, as well as how closely matched the efforts are to the culture. Alison Robins, writer for OfficeVibe, explains that being socially responsible can help attract positive attention from outside of a company. Some examples include:

Talent attraction. Many companies offer employees paid time off to participate in volunteer activities, including travel to other nations. Who wouldn't want to work for a company that cares so much about a personal cause? Corporate social responsibility is often used as a recruitment tool to attract people who care about giving back to their communities and making changes that impact the world.

Consumer influence. A major benefit of engaging in corporate social responsibility efforts is that consumers regularly check in with their favorite brands to see what they are doing, and they are influenced to make purchases so they can be part of this community. With the process of posting messages on social networks, entire movements can take off via the support of loyal consumers.

Promoting Corporate Responsibility with Marketing

After reviewing the benefits of corporate social responsibility and some of the examples provided by popular companies, it is easy to see how important proper marketing can be to to this effort. As you can see from the following example of Tom's One for One™ program, marketing is used as a reminder for consumers that the company is committed to providing one pair of shoes to a child in an undeveloped nation for every pair purchased by a consumer.

Marketing is powerful in terms of the consumer market. It has been estimated by the brand marketing news source *Adweek* that millennials represent around $2.45 trillion in spending per year. Cone Communications, a public relations and marketing agency, found that 60 percent more millennials will engage with brands that discuss and market to social issues. Younger consumers are attracted to brands that authentically market their products alongside social responsibility campaigns.

However, one should not use corporate social responsibility as a marketing pitch for a company. Consumers will quickly pick up on this tactic, and it can damage the brand. Nicole Fallon, who contributes to *Business News Daily*, reveals, "The motivation behind many companies' CSR efforts actually provides the very reason that they shouldn't take on socially responsible initiatives." Motivations such as competitive positioning and profitability are not authentic when it comes to corporate social responsibility.

It is also important to distinguish between corporate social responsibility and social marketing. Often used interchangeably, there are some key differences. Social marketing attempts to change the attitudes and behaviors of consumers by using a variety of marketing methods. However, corporate social responsibility is a sustainable effort that can be measured. Bernard Okhakume, a brand management consultant, advised Daily Times, "For a corporate social responsibility project to be successful, several factors come into play: the project needs to be sustainable, its topic and practice abide by ethical standards, sensitive to society's needs, embraced and supported by the company's employees, create the aimed effect on the target audience, and every year, and the project needs to be evaluated to see how beneficial it is."

The Financial Impact of the Triple Bottom Line

When examining the value of corporate responsibility, one must understand the concept of the triple bottom line (TBL), which essentially measures the sustainability of an organization's social responsibility efforts. The term includes three dimensions of a giving business—profits, people, and the planet. Without one of these factors, there cannot be a balance. According to economist Andrew Savitz, the triple bottom line "captures the essence of sustainability by measuring the impact of an organization's activities on the world ... including both its profitability and shareholder values and its social, human and environmental capital."

The challenge with the TBL model is that while profits can be measured in dollars, and people can be measured in numbers, it can be difficult to measure the impact of social responsibility. Some argue that this task is dependent upon what is being measured. For example, if one is saving the rainforest, a reasonable unit of measurement could be acreage. Progress toward protecting this resource could be recorded as how many fewer acres have been forested and how many native (people) communities have been saved as a result of the intervention.

Another example could be a social cause, such as creating housing for single parents in poverty-stricken neighborhoods in a specific city. The impact can be felt in terms of the additional housing that is created (built or rehabbed from existing homes), and the value that this effort brings to the neighborhood. The number of people helped can be measured. The city's rate of homelessness can be measured as it is reduced. Then, there are other equally important results of social responsibility that can be considered, such as the reduced rate of crime in areas with homeowners, and an increase in employment for those who own the homes. These indirect benefits have an impact on the company because it can eventually hire people from these areas of the city.

Businesses must be continually mindful of the image that they project to the world and be sure to align their corporate social responsibility campaigns with their culture. An authentic cause that is backed by all is far better than one that is dreamt up purely for the sake of marketing.

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3.4: End Notes

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3.E: Assessment Questions

1. Define business ethics.

Answer

Acceptable levels of behavior for each individual who makes up the organization.

2. Who decides the business ethics for a company?
    a. The HR department.
    b. The employees.
    c. Leadership.
    d. Consultants.
3. All of the following are examples of results of unethical business actions except:
    a. Recruitment and retention problems.
    b. Lower employee salaries.
    c. Negative employee relations.
    d. Poor company reputation.

Answer

b

4. Ethical rules can be based on deep values of an organization which may include:
    a. Quality of products and services.
    b. Commitment to customers.
    c. How the organization gives back to the community.
    d. All of the above.
5. According to Kimberlee Leonard of the Houston Chronicle the elements that belong in a Code of Conduct for a company include all of the following except:
    1. Office Hours.
    2. Professional behaviors.
    3. Regulatory ethics.
    4. Legal considerations.

Answer

a

6. What's the definition of Corporate Responsibility?
7. Where did the term Corporate Responsibility originate?

Answer

The earliest published book about the topic is Corporate Responsibility of the Businessman, published in 1953. This book introduced the concept of companies giving back as a form of investment in the future. This idea came from a generation that had survived some of the hardest times in our world and wanted to make it a better place for generations to come.

8. The benefits of Corporate Responsibility for a business include:
    a. Talent attraction.
    b. Consumer influence.
    c. Improved perception by investors.
    d. All of the above.
9. The three dimensions of the triple bottom line include all of the following except:

a. Profits.
b. People.
c. Planet.
d. Promotion.

Answer

d

10. Distinguish between corporate social responsibility and social marketing.

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CHAPTER OVERVIEW

4: Business and the United States Constitution

4.1: Introduction
4.2: Commerce Clause
4.3: Constitutional Protections
4.4: End Notes
4.E: Assessment Questions

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4.1: Introduction

Learning Objectives

- Explain the impact of the U.S. Constitution on business.



Figure 4.1.1: Introduction (Credit: geralt/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

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4.2: Commerce Clause

The Constitution and the Law

Federal and state constitutions are a major source of business law. **The United States Constitution** is the supreme law of the United States. In addition to the individual constitutions established in each state, the U.S. Constitution sets out the fundamental rules and principles by which the country and individual states are governed. Constitutional law is the term used to describe the powers and limits of the federal and state governments as established in the Constitution. The political system that divides authority to govern between the state and federal governments is known as **federalism**, and this too is established in the Constitution. The Tenth Amendment states that any area over which the federal government is not granted authority through the Constitution is reserved for the state. This statement means that any federal legislation impacting business and commerce must be established by an expressed constitutional **grant of authority**.



Figure 4.2.1: The United States Constitution is the supreme law of the land. (Credit: 1778011/ pixabay/ License: CC0)

Federal Preemption

The Founding Fathers created a federal system that would, at times, "preempt" state law through the **supremacy clause**, outlined in Article VI of the Constitution. In other words, since the U.S. Constitution is the "supreme law of the land," if a state law conflicts with the U.S. Constitution, the state law is declared invalid. When the federal constitutional law prevails over the state law, it is said that the state law has been **preempted**. Before that determination is made, the courts try to determine if Congress intended to preempt state law in enacting the particular provision in question. If the answer is "no," then those who are asserting protections of state law may make claims under state law. If the answer is "yes," however, federal law prevails.

The Tenth Amendment to the Constitution gives the states powers over areas of law not held exclusively by the federal government through the U.S. Constitution, e.g., states can make laws about how to get married, who may get married, or how to dissolve a marriage, as well as which activities are crimes and how the crimes will be punished. If the U.S. Constitution does give the federal government some power, however, then the federal government may exercise it, free from state interference. For instance, the U.S. Congress (the legislative branch of the federal government) has the power, among other things, to coin money, to create a military, to establish post offices, and to declare war. Since there is specific mention of these powers, states may not create their own currency, military, or postal service, and they may not declare war.

The Commerce Clause and The Affordable Care Act

After much debate, negotiation, and political wrangling, Congress passed the Patient Protection and Affordable Care Act (PPACA) in 2010, which was designed to increase the number of Americans who had access to health insurance (a policy initiative known as Obamacare). The Act included a provision mandating that individuals not insured through employment or who were otherwise exempt from receiving health insurance obtain minimum essential health insurance or face a penalty issued through the Internal Revenue Service (IRS). The National Federation of Independent Business (NFIB), supported by 26 of the 50 states, challenged the constitutionality of this particular provision, known as the individual mandate. Their argument was upheld by the 11th Circuit

Court of Appeals, which ruled that Congress did not have the authority to enact this provision. Later, however, the appellate court determined that the individual mandate was severable from the remainder of the PPACA, so ultimately the Act was upheld.

The main source of authority for the federal regulation of interstate and international commerce is the **commerce clause**. This clause is established in Article I, Section 8, of the Constitution. The Article grants Congress the power to "regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." Thus, the commerce clause serves to simultaneously empower the federal government, while limiting state power.

So long as a federal regulation impacts interstate commerce, that regulation can be described as constitutional, according to the commerce clause. However, since the Constitution was first written, there have often been occasions when the judiciary system has needed to step in to interpret the meaning and implications of the commerce clause. In particular, there have been disputes over the intended meaning of the phrase "among the several States." Up until the 1930s, this phrase was interpreted in a literal way, so that activities subject to federal regulation were required to involve trade between the states. This strict interpretation actually served to limit the federal regulation of commerce.

The turning point in the interpretation of the commerce clause came with the 1937 case, *NLRB v. Jones & Laughlin Steel Corp*. The previous year, in the *Carter v. Carter Coal Co* case, the court invalidated a program, initiated under the New Deal, that had tried to regulate the labor practices of coal firms on the basis that these practices were local, and therefore had only an indirect impact on interstate commerce. In *NLRB v. Jones & Laughlin Steel Corp*, the court deviated from that decision by ruling that Congress could regulate employment practices at a steel plant because any stoppages at that plant would have a serious, detrimental impact on interstate commerce. The court concluded that since the steel industry is a networked industry that incorporates mines, plants, and factories from Minnesota to Pennsylvania, the manufacturing of steel properly falls under the jurisdiction of the commerce clause. In summing up, the court concluded that:

> *"Although activities may be intrastate in character when separately considered, if they have such a close and substantial relationship to interstate commerce that their control is essential or appropriate to protect that commerce from burdens or obstructions, Congress cannot be denied the power to exercise that control" (NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1 1937).*

Challenges to and Reinterpretations of the Commerce Clause

Ever since the *NLRB v. Jones & Laughlin Steel Corp* case, Congress has invoked the commerce clause to rule on a diverse range of business and commercial activities, as well as to support social reforms that indirectly impact state commerce. Examination of the United States Code reveals that there are more than 700 legislative provisions that explicitly refer to foreign or interstate commerce. What is perhaps most remarkable is the sheer diversity of statutory areas covered by the commerce clause. Areas covered include the regulation of sporting activities, endangered species, energy regulation, gambling, firearms control, and even terrorism.

Examples of Federal Legislation Passed by Invoking the Commerce Clause

- The Controlled Substances Act
- The Federal Mine Safety and Health Act
- The Civil Rights Act
- Americans with Disabilities Act
- The Indian Child Welfare Act

While businesses have often challenged these statutes as existing outside of the realm of congressional authority, in most cases, the courts have upheld the statutes as being valid exercises of congressional power in line with the commerce clause. An exception is the 1995 case, *United States v. Lopez*. The case centered around the legality of the Gun-Free School Zone Act, which was a federal law that outlawed the possession of guns within 1,000 feet of a school. In a landmark case, the Court ruled that the Act was outside the scope of the commerce clause, and that Congress did not have the authority to regulate in an area that had "nothing to do with commerce, or any sort of enterprise."

A recent controversy pertaining to the commerce clause relates to the passing of the Affordable Care Act, as described earlier. Protestors claimed that the individual mandate aspect of the ACA should be treated as a regulation that affects interstate commerce. According to their argument, after the Act was implemented, there would be an increase in the sale and purchase of health care

insurance, such that the market for health care should be seen as being significantly impacted by the Act. However, the Chief Justice of the Supreme Court, Justice Roberts, ruled that actions that create new business activity do not affect interstate commerce.

Police Power and the Dormant Commerce Clause

The authority of the federal government to regulate interstate commerce has, at times, come into conflict with state authority over the same area of regulation. The courts have tried to resolve these conflicts with reference to the **police power** of the states.

Police power refers to the residual powers granted to each state to safeguard the welfare of their inhabitants. Examples of areas in which states tend to exercise their police power are zoning regulations, building codes, and sanitation standards for eating places. However, there are times when the states' use of police power impacts interstate commerce. If the exercise of the power interferes with, or discriminates against, interstate commerce, then the action is generally deemed to be unconstitutional. The limitation on the authority of states to regulate in areas that impact interstate commerce is known as the **dormant commerce clause**.

In using the dormant commerce clause to resolve conflicts between state and federal authority, the courts consider the extent to which the state law has a legitimate purpose. If it is determined that the state law has a legitimate purpose, then the court tries to determine whether the impact on interstate commerce is in the interest of the citizens of the state, and will rule accordingly. For instance, an ordinance that banned spray paint, issued in the city of Chicago, was challenged by paint manufacturers under the dormant commerce clause, but was ultimately upheld by the U.S. Court of Appeals because the ban was intended to reduce graffiti and related crimes.

Today, Congress uses its authority to regulate commercial activity in four general areas relating to the commerce clause:

1. Regulation of the channels of interstate commerce
2. Regulation of the instrumentalities of interstate commerce
3. Regulation of intangibles and tangibles that cross state lines
4. Regulation of activities that are deemed to be both economic and to have a substantial impact on interstate commerce

Table 4.2.1

Area of Regulation	Explanation	Examples
Regulation of the **channels** of interstate commerce	Channels of interstate commerce describe the passages of transportation between the states. Thus, the commerce clause authorizes Congress to regulate activities pertaining to the nation's airways, waterways, and roadways, and even where the activity itself takes place entirely in a single state.	For example, Congress can pass regulations that restrict what can be carried on airlines or on ships.
Regulation of the **instrumentalities** of interstate commerce	Instrumentalities of commerce are understood to be any resource employed in the carrying out of commerce. Examples of these resources are machines, equipment, vehicles, and personnel. Thus, Congress has the power to regulate these areas.	Congress could pass regulations mandating certain safety standards for equipment used in manufacturing plants.
Regulation of intangibles and tangibles that **cross state lines**	Any object, tangible or intangible, that crosses state lines can be regulated under the commerce clause. Tangible objects include goods purchased by consumers, as well as raw materials and equipment used in the production of goods for sale. Intangible objects include services, as well as electronic databases.	The Driver's Privacy Protection Act (DPPA) regulates the sale of information contained in the Department of Motor Vehicles' (DMV's) records.
Regulation of activities that are deemed to have a **substantial impact** on interstate commerce	Federal regulation of economic commercial activity expected to have a significant (as opposed to minor) effect on interstate commerce is constitutional, according to the commerce clause. Noneconomic commercial activity is not covered.	The courts in the United States vs. Lopez case described earlier deemed the Act to be unconstitutional because its terms have "nothing to do with 'commerce' or any sort of economic enterprise."

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4.3: Constitutional Protections

The Bill of Rights is the common term given to the first 10 amendments to the U.S. Constitution. These are not the only set of amendments to the Constitution, but they are considered together as impacting rights because they limit the ability of the federal government to infringe upon individual freedoms. In addition, a later amendment, the Fourteenth Amendment, extends the provisions set out in the Bill of Rights to the states, in addition to federal government. The Bill of Rights has a substantial impact upon government regulation of commercial activity, and therefore, it is important to fully understand it.

A summary of the provisions of the Bill of Rights is supplied below:

Table 4.3.1

Amendment	Provision
First	Ensures that U.S. citizens have the right to freedom of speech, press, religion, and peaceable assembly. Provides citizens with the right to appeal to government to redress grievances.
Second	Establishes that the government cannot infringe upon citizens' right to bear arms. Establishes the importance of a militia for national security.
Third	Establishes that the government cannot quarter soldiers in private houses during peacetime or wartime.
Fourth	States that government can only issue warrants with probable cause and protects U.S. citizens from unwarranted search and seizure.
Fifth	Establishes rights of due process. Ensures that indictment of a grand jury is necessary to put a citizen on trial and grants citizens the right not to testify against themselves.
Sixth	Provides citizens with the right to an expeditious public trial, the right to an attorney, and the right to an impartial jury.
Seventh	States that citizens have the right to a trial by jury for common lawsuits involving monetary value of $20.
Eighth	Prohibits cruel and unusual punishment, prevents the imposition of excessive fines, and states that the government cannot set bail at excessive amounts.
Ninth	States that the rights set out in the Bill of Rights do not remove any other rights granted to citizens.
Tenth	States that any area over which the federal government is not granted authority through the Constitution is reserved for the states.

Application of the Bill of Rights to Commercial Activity

The protections afforded the citizenry in the Bill of Rights are also extended to corporations and commercial activities. In the next sections, some applications of the various amendments in the area of business are discussed.

The First Amendment

The freedom of speech provisions in the First Amendment have application to corporations. The courts distinguish between different types of speech, and each has implications for the power of the federal government and states to regulate in these areas:

1. **Corporate Political Speech**. Political speech is any speech used to support political agendas or candidates. Until the 1970s, several states prevented firms from financially supporting political advertising because they feared the power of corporate assets. However, since the 1978 case *First National Bank of Boston v. Bellotti*, it has been established that corporate political speech is protected in the same way as citizens' free speech.
2. **Unprotected Speech**. The 1942 case *Chaplinsky v. New Hampshire* determined that certain types of speech—that which could "inflict injury or incite an immediate breach of the peace"—is not protected under the First Amendment. Therefore, obscenities, defamation, and slanderous speech are not protected.
3. **Commercial Speech**. This type of speech conveys information pertaining to the sale of goods and services. Ever since the 1980 case *Hudson Gas & Electric Corp v. Public Service Commission of New York*, a four-part test has been established to determine whether commercial speech should be regulated according to the First Amendment. This test is known as **The Central Hudson Test for Commercial Speech**.

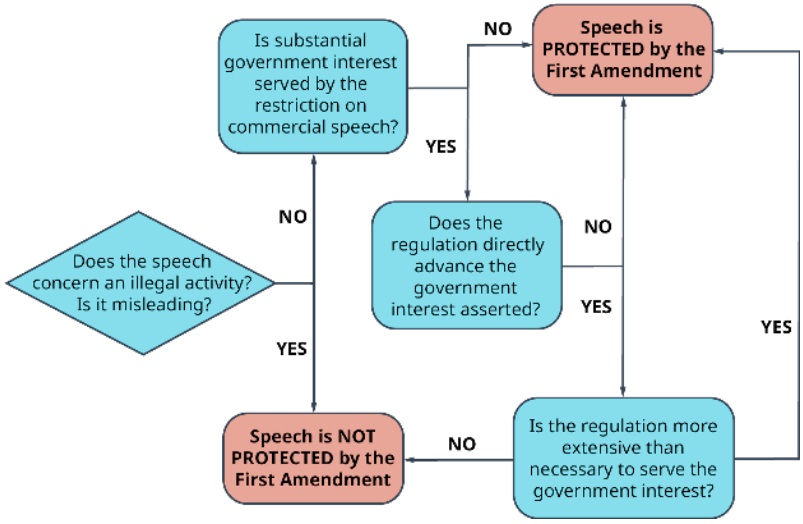


Figure 4.3.1: Hudson Gas & Electric Corp v. Public Service Commission of New York established a four-part test to determine whether commercial speech should be regulated according to the First Amendment. (Modification of art by BNED/pixabay Credit: CC BY NC SA)

The **free exercise clause** of the First Amendment states that government is prohibited from making laws that prohibit the free exercise of religion. Issues pertaining to this clause often arise in organizational settings. For example, historically, there have been a number of cases in which government employees have challenged employers' attempts to inhibit their exercise of religious practice (e.g., the wearing of religious symbols) in the workplace.

The Fourth Amendment

The Fourth Amendment guarantees that citizens are free from unreasonable searches and seizures, and requires government officials to obtain **search warrants** to conduct searches. However, government officials can only request a search warrant if they have **probable cause** to believe that criminal activity is occurring at the location of the search, or that they will locate evidence of criminal activity during the search (except where the official believes items will be removed prior to obtaining a warrant). The Fourth Amendment protects individual organizations and places of business, as well as residences. However, under the terms of the **pervasive-regulation exception**, administrative agencies can conduct warrantless searches of businesses attached to industries that have a long history of pervasive regulation. For example, public health agencies are allowed to conduct warrantless searches of stone quarries, as authorized by the Federal Mine Safety and Health Act of 1977.

The Fifth Amendment

For commercial enterprises and businesspeople, it is the **due process clause** of the Fifth Amendment that offers the most extensive protection. The clause states that the government cannot take an individual's life, liberty, or property without due process of law. Specifically, there are two types of due process:

- **Substantive due process** means that laws that will deprive an individual of his or her life, liberty, or property must be fair and not arbitrary. Laws passed should not affect fundamental rights, and regulations are required to meet the **rational-basis test**. In

other words, the government must demonstrate that the law bears a rational relationship to a legitimate state interest. Many regulations affecting commercial activity, such as banking regulations, minimum wage laws, and regulations inhibiting unfair trade, have been tested against the rational-basis test.

- **Procedural due process** means that governments must use fair procedures when depriving an individual of his or her life, liberty, or property. This status quo does not only apply to federal criminal proceedings. For example, if a government employer discharges an employee from his job, or if the government suspends the driver's license of a worker, the employer must follow procedural due process.

Another clause contained in the Fifth Amendment that is relevant to commercial enterprises is the **takings clause**. According to this clause, when the government seizes private property for public use, it is required that the government pay the owner **just compensation** for the property. Just compensation is understood to be equivalent to the market value of the property. This clause has been broadly interpreted. For example, if environmental or safety regulations significantly impact the way in which a property owner can use his or her land for economic gain, the regulation can essentially be deemed as depriving the owner of his or her land, and the owner is entitled to compensation.

It is important to note that the **privilege against self-incrimination**, established under the Fifth Amendment (usually interpreted as the right to remain silent), only applies to sole proprietorships that are not legally distinct from the individual who owns them. Custodians and agents of corporations do not enjoy this privilege.

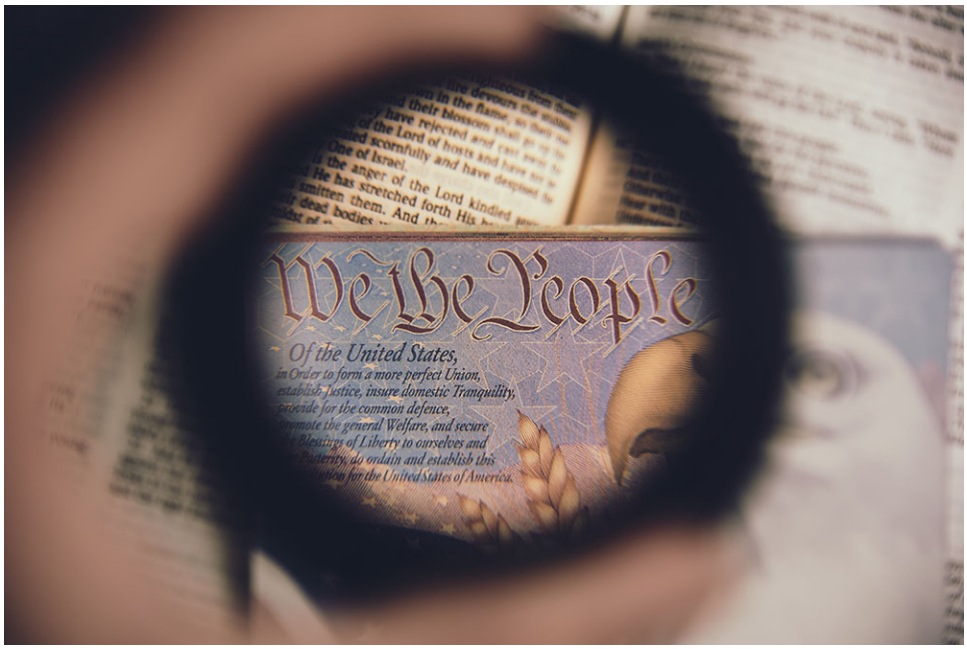


Figure 4.3.2: The various protections afforded the citizenry in the Bill of Rights are also extended to corporations and commercial activities. (Credit: Anthony Garand/ unsplash/ License: Unsplash License)

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4.E: Assessment Questions

1. Explain Police Power and the Dormant Commerce Clause.

Answer

The authority of the federal government to regulate interstate commerce has, at times, come into conflict with state authority over the same area of regulation. The courts have tried to resolve these conflicts with reference to the police power of the states.

Police power refers to the residual powers granted to each state to safeguard the welfare of their inhabitants. Examples of areas in which states tend to exercise their police power are zoning regulations, building codes, and sanitation standards for eating places. However, there are times when the states' use of police power impacts interstate commerce. If the exercise of the power interferes with, or discriminates against, interstate commerce, then the action is generally deemed to be unconstitutional. The limitation on the authority of states to regulate in areas that impact interstate commerce is known as the dormant commerce clause.

In using the dormant commerce clause to resolve conflicts between state and federal authority, the courts consider the extent to which the state law has a legitimate purpose. If it is determined that the state law has a legitimate purpose, then the court tries to determine whether the impact on interstate commerce is in the interest of the citizens of the state, and will rule accordingly. For instance, an ordinance that banned spray paint, issued in the city of Chicago, was challenged by paint manufacturers under the dormant commerce clause, but was ultimately upheld by the U.S. Court of Appeals because the ban was intended to reduce graffiti and related crimes.

2. The Patient Protection and Affordable Care Act's (also known as Obamacare) provision that mandated that individuals not insured through employment obtain minimum essential health insurance or face a penalty was upheld as constitutional by the 11th Circuit.
   a. True.
   b. False.
3. The _____ gives the federal government the authority to regulate interstate and international commerce.
   a. Supremacy Clause.
   b. 10th Amendment.
   c. Bill of Rights.
   d. Commerce Clause.

Answer

d

4. The doctrine aimed at dividing the governing powers between the federal governments and the states is:
   a. Judicial review.
   b. Federalism.
   c. Separation of powers.
   d. Preemption.
5. The doctrine aimed at dividing the governing powers between the federal governments and the states is:
   a. Commerce Clause.
   b. Superior Clause.
   c. Supremacy Clause.
   d. Necessary and Proper Clause.

Answer

c

6. Describe the 2 types of Due Process.
7. The _____ of the constitution offers the most extensive protection for businesses

7. The _____ of the constitution offers the most extensive protection for businesses.
   a. Supremacy Clause.
   b. Equal Protection Clause.
   c. Due Process Clause.
   d. Freedom of Speech Clause.

Answer

c

8. The 14th Amendment is a part of the Bill of Rights.
   a. True.
   b. False.
9. Which of the following is correct with regards to the powers of state government in the United States?
   a. All powers not specifically enumerated to the federal government are reserved to the states.
   b. The power over crimes is reserved to the federal government.
   c. The power over the militia is reserved to the states.
   d. The powers over the federal government are superior to every state power.

Answer

a

10. All of the sections of the Bill of Rights apply to corporations and commercial activities.
    a. True.
    b. False.

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CHAPTER OVERVIEW

5: Criminal Liability

5.1: Introduction

5.2: Common Business Crimes

5.3: Civil vs. Criminal Liability

5.4: End Notes

5.E: Assessment Questions

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5.1: Introduction

Learning Objectives

- Analyze sources of criminal exposure in business.



Figure 5.1.1: Introduction Lady Justice by Arend Ode(Image Credit: AJEL/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

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5.2: Common Business Crimes

People rarely think about their conduct at work as being potentially illegal, or that jail time could result from poor workplace decisions. However, this fact is the reality. Organizations are fined, and executives are sentenced to jail, when business laws are broken. Many of the workplace violations are nonviolent crimes, such as fraud, property crimes, or drug- or alcohol-related infractions. Regardless of the level of violence or the employee's motivation for committing the crime, breaking the law can lead to negative consequences for the business, its employees, and its customers.

Constitutional Authority to Regulate Business

Congress is given the power to "regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." Our forefathers wanted to facilitate easier trade among the states by allowing Congress to adopt rules that could be uniformly applied. The theory was that if commercial enterprises knew that they would be dealing with essentially the same rules across the nation, it would be much easier to run their businesses and keep commerce flowing more efficiently.

While federal courts initially interpreted the commerce power narrowly, over time, the federal courts have decided that the commerce clause gives the federal government broad powers to regulate commerce, not only on an **interstate** (between the states) level, but also on an **intrastate** (within each state) level, as long as some economic transaction is involved. The federal government does not usually exceed its regulatory powers.

White Collar Crime

White collar crimes are characterized by deceit, concealment, or violation of trust. They are committed by business professionals. They generally involve fraud, and the employees committing the crimes are motivated by the desire for financial gains or fear of losing business standing, money, or property. **Fraud** is the intentional misrepresentation of material facts for monetary gain. This type of crime is not dependent on threats or violence.



Figure 5.2.1: White collar crimes are committed by business professionals within businesses with the intent of gaining or maintaining status. (Credit: Rawpixel/ pexels/ License: CC0)

White collar crimes tend to violate state laws, and sometimes federal laws. The violation depends on what is involved in the crime. For instance, criminal acts involving the United States postal system or interstate commerce violate federal law.

Although white collar crimes do not need to include physical violence, these types of crimes can destroy companies, the environment, and the financial stability of clients, employees, and communities. In 2018, Jeremiah Hand and his brothers, Jehu Hand and Adam Hand, were convicted and sentenced to between 9 and 30 months in prison for their respective roles in a **pump-and-dump** scheme. In this scheme, they were dishonest about control over their company's stock, and even went as far as filing false forms in an effort to raise the value of the stock. Once the value of the stock was raised, they released their shares into the market.

Types of Business Crimes

Business crimes or white collar crimes are not limited to pump-and-dump schemes; they come in many different forms. Business crimes come in many different forms. As previously stated, these crimes often involve deceit, fraud, or misinformation. The types of high-profile crimes include Ponzi schemes, embezzlement, and crimes that intentionally violate environmental laws and regulations. This section will explore these three types of crimes and provide examples from the 2000s.

Ponzi Schemes

Ponzi schemes (also known as pyramid schemes) are investing scams that promise investors low-risk investment opportunities with a high rate of return. The high rates are paid to old investors with money acquired from the acquisition of new investors. The performance of the market is not a factor in the investors' rate of return.

Bernie Madoff operated a 20-year Ponzi scheme through his company. He paid high returns (above average) using the investments of new clients (investors). In 2008, investors attempted to withdraw funds, but the Madoff organization was not able to provide the reimbursement. Madoff is currently serving a more than 100-year sentence in prison.

Larceny and Embezzlement

Larceny and embezzlement are two forms of theft that can occur within a business. **Larceny** occurs when a person unlawfully takes the personal property of another person or a business. For example, if an employee takes another employee's computer with the intent of stealing it, he or she may be guilty of larceny. In contrast, **embezzlement** occurs when a person has been entrusted with an item of value and then refuses to return it or does not return the item. For example, if an employee is entrusted with the petty cash at his or her office and that person purposefully takes some of the money for himself or herself, this would be embezzlement.

One high-profile example of embezzlement occurred at Koss Corporation in Milwaukee, Wisconsin. Sujata "Sue" Sachdeva was a Vice President of Finance and Principal Accounting Officer at Koss Corporation. Sachdeva was convicted of embezzling $34 million over a 5-year period and sentenced to 11 years in federal prison, as well as restitution to Koss Corporation. Sachdeva was entrusted with the company's funds and did not utilize the funds as intended.

Environmental Crimes

Many federal statutes regulate the environment. Many of these laws carry both civil and criminal penalties for violations.

The following federal laws can carry criminal penalties:

- Clean Air Act
- Clean Water Act
- Resource Conservation and Recovery Act
- Comprehensive Environmental Response, Compensation and Liability Act
- Endangered Species Act

The International Petroleum Corporation of Delaware (IPC) is paying restitution for environmental crimes, which included a scheme to violate the Clean Water Act. From 1992 to 2012, IPC processed oil and wastewater. The company admitted to altering required water test samples so they met the limits set by their permit before releasing the waste into the city's sewer system. The company also admitted to transporting waste that contained benzene, barium, chromium, cadmium, lead, PCE, and trichloroethene for disposal in South Carolina without the required reporting of the information, which also violated environmental laws.



Figure 5.2.2: White collar crimes are generally motivated by the desire to maintain or gain financial status. (Credit: TheDigitalWay/ pixabay/ License: CC0)

Other Types of Business Crime

The business environment is complex, and some crimes are less common or receive less media attention. These types of crimes include those that violate antitrust laws, racketeering, bribery, money laundering, and spamming.

Violations of Antitrust Laws

Antitrust laws do not allow activities that restrain trade or promote market domination. These laws are in place to provide guidance and supervision of mergers and acquisitions of companies to prevent market abuse. The goal is to avoid **monopolies**, or the control of one organization over a specific market. Monopolies reduce competition and, as a result, can have a detrimental impact on consumer prices. Since the United States is founded on capitalist principles, anti-competitive business conduct is prohibited by law, and some of those laws, such as the Sherman Antitrust Act, do include provisions about criminal punishment.

Racketeering

Racketeering activities include loan-sharking, money laundering, and blackmailing. In the past, the term has been used to describe organized crime. The term is now applied to other entities, as well. RICO, or the Racketeer Influenced and Corrupt Organizations Act, is a federal law aimed at preventing and prosecuting by both businesses and organized crime syndicates. “RICO is now used against insurance companies, stock brokerages, tobacco companies, banks, and other large commercial enterprises.” (Schodolski, 2018). Racketeering is no longer limited to organized crime. Health insurance companies and other legitimate businesses are being accused of pressure tactics similar to those used in organized crime racketeering. These claims involve allegations of lying about the actual cost of care, damaging the business for physicians, bullying patients, and attempting to control the doctor-patient relationship through lies and pressure tactics.

Bribery

Bribery occurs when monetary payments, goods, services, information, or anything of value is exchanged for favorable or desired actions. You can be charged with bribery for offering a bribe, or taking a bribe. Bribery is illegal within the United States and outside of it. The Foreign Corrupt Practices Act prohibits bribery payments by U.S. companies to foreign government officials with an intent to influence foreign business results. One example of bribery would be a situation in which a pharmaceutical company offers special benefits to individuals who agree to prescribe their medications.

Money Laundering

Money laundering refers to taking “dirty”money, or money obtained through criminal activities, and passing it through otherwise legitimate businesses so that it appears “clean.” The money cannot be tied back to the illegal acts. Clean money is money that was obtained through legitimate business functions.

Spamming

Sending unsolicited commercial email, or spam, is illegal. While the onus is on consumers to avail themselves of whatever programs they can to block spam, laws are in place to discourage the sending of spam. The following points are outlined in the anti-spam legislation in Washington state and are similar to other legislation:

1. Individuals may not initiate the sending or plan the sending of an email that misrepresents the sender as someone he or she is not, represents the sender as being associated with an organization that he or she has no association, or otherwise hides the identity of the sender or origin of the email. Email messages may not have false or misleading information in the subject line of the message.
2. Commercial emails must include the contact information of the sender and the receiver must be aware that the message is from a commercial source.

States like Washington are putting legislation in place to reduce spam and asking consumers to take an active role in addressing spam. In general, legislators realize that spam is a nuisance and are finding ways to hold companies liable for sending spam messages.

Conclusion

It is important to know that not all people charged with business crimes or white collar crimes are necessarily guilty. A person must be found guilty of the crime before he or she is convicted. Regardless, business crimes and white collar crimes negatively impact the individual, the organization he or she worked for, the community, and customers.

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5.3: Civil vs. Criminal Liability

A legal case can be civil or criminal. Each case has different components and requirements. Before one can understand the civil and criminal systems, it is important to understand the aspects of both civil and criminal laws. The scope, consequences, and treatments of each vary.

Constitutional Rights

It is important to understand the Constitution, which is the basis of all law. States are allowed to create and categorize crimes and punishment, as long as they do not violate rights protected by the U.S. Constitution. For example, in a fairly recent United States Supreme Court case, Lawrence v. Texas, the defendants asserted the unconstitutionality of a Texas law (enacted by the Texas legislature) regarding a particular act. When the United States Supreme Court ruled it unconstitutional, Texas could no longer enforce it.

Frequent issues litigated in the courts are:

- Whether evidence must be suppressed (not allowed to be introduced at trial) because it was obtained pursuant to an unreasonable search and seizure (violating the Fourth Amendment). This category might involve a sub-issue about whether officers had sufficient probable cause to conduct a warrantless search. Without a warrant, and without the suspect's consent, officers generally may only conduct searches if they have "probable cause" to do so; any evidence obtained without consent or probable cause can be objected to, and ultimately ruled inadmissible by the court in trial, if illegally obtained.
- Whether evidence must be suppressed because it was obtained while the suspect was "in custody" without advising a suspect of his rights to remain silent, to speak to an attorney, and to the appointment of an attorney if he cannot afford one (Fifth Amendment privilege against self-incrimination and Sixth Amendment right to counsel), as required by the Supreme Court in the famous Miranda v. Arizona case. The term often used to describe these rights is "Mirandizing," which is named after the case.
- Whether a state law or constitutional provision provides more protection than the U.S. Constitution.



Figure 5.3.1: Both civil and criminal convictions are based on precedent. (Credit: PactoVisual/ pixabay/ License: CC0)

Components of Crime

There are usually two components to criminal conduct that must be proven by the prosecutor. The prosecutor prosecutes the case against the accused: **mens rea** (the criminal, or guilty, or "wrongful" mind) and **actus reus** (the criminal, or guilty, or "wrongful" act).

Each statute creating a crime is supposed to include a description of:

a. the mental state (**mens rea**) required to establish that the suspect committed the crime, coupled with
b. a description of the conduct (**actus reus**) that the suspect must have done.

The statute generally also indicates the category of crime (felony/misdemeanor/gross misdemeanor).

Criminal Procedures

Generally, the first pleading filed by the prosecutor is called the **information**. (This step could be described as the criminal counterpart to a civil "complaint.")

The next stage is called the **arraignment**, where the defendant appears in court so that the court can determine or confirm his or her identity, inform the defendant of the charge the prosecutor has filed against him or her, and hear the defendant's plea.

Then, there will be discovery and trial. In criminal cases, the jury will convict only if convinced "beyond a reasonable doubt" that the defendant committed the crime, and the verdict must be unanimous. This type of case involves a higher burden of proof than in civil cases.

Criminal and Civil Law

Criminal law addresses behaviors that are offenses against the public, society, or state. Examples of criminal law offenses include assault, drunk driving, and theft. In contrast, **civil laws** address behavior that causes an injury to the private rights of individuals in areas such as child support, divorce, contracts, property, and the person. Examples of civil law offenses include libel, slander, or contract breaches.

Criminal and civil cases differ in who initiates the case, how the case is decided, what punishments or penalties are issued, requirements of proof, and legal protections provided.



Figure 5.3.2: Civil and criminal cases involve the court system. (Credit: Brett Sayles/ pexels/ License: CC0)

Initiation and Roles

Criminal and civil cases are initiated differently, and the titles of the individuals involved differ slightly. Criminal cases are only initiated by the federal or state government in response to a law being broken. The federal or state governments are known as the prosecution. The prosecution is an attorney, or group of attorneys, hired by the government to present a case against the accused. Criminal cases are usually titled something like "State v. [last name of the defendant accused of a crime]." In criminal prosecutions, the victim is not a party to the lawsuit, but might be a witness for the state at the trial.

In contrast, private parties initiate civil cases when they feel that someone has injured them. Again, civil cases stem from breach of contract, custody cases, and attacks on one's character. Private parties can include an individual, a group, or a business. The person, group, or business who initiates the case is referred to as the plaintiff or complainant. The accused is referred to as the defendant, in both criminal and civil proceedings.

Typically, there is a difference in the burden of proof for the two types of cases. In a criminal case, the defendant must be proven guilty "beyond a reasonable doubt." In a civil case, the defendant must be proven liable through a "preponderance of the evidence." In other words, the prosecution in a civil case must prove that it is more probable than not that the defendant is liable.

In criminal cases, the defendant is entitled to an attorney and may be appointed an attorney if he or she is not able to afford one. The state appoints the attorney. In contrast, all parties involved in a civil case are required to secure their own legal representation.

Typically, civil and criminal laws use different terminology, and being found guilty or accountable in each type of case results in different consequences.

In a civil action (lawsuit), the plaintiff is the person who is alleging that he or she has actually been harmed (physically, financially, or in another manner), and the defendant is the one who is asked to pay damages or otherwise compensate the plaintiff. Outside of financial compensation, the plaintiff may be ordered to do something or refrain from doing something, which is referred to as injunctive relief.

In the Liebeck v. McDonald's case, a woman sued McDonald's for serving hot coffee. The woman spilled hot coffee on her lap while trying to add cream and sugar. The woman sued McDonald's for negligence in a civil suit. The issue centered on whether or not the coffee's specific temperature was unreasonably hot. McDonald's lost the lawsuit. The compensatory verdict was $\$160,000$. McDonald's was found liable.

Conversely, if a defendant is convicted of committing a crime, the consequences are usually incarceration (jail/prison) and/or a fine (payment of money to the state).

The word used to describe the legal responsibility for harm in a civil case is liability, not guilt. Guilty is the word used to describe a person found guilty of committing a crime in a criminal case.

Businesses can be charged with criminal acts as well. In 2017, Oliver Schmidt, former manager of a Volkswagen engineering office near Detroit, was arrested. He faced years in prison for attempts to defraud the United States, wire fraud, violation of the Clean Air Act, and a charge of giving an untrue statement under the Clean Air Act. Schmidt's actions directly violated a business law and, since his actions violated an established law, he was held criminally liable. In December of 2017, Schmidt was sentenced to seven years in prison.

Professional Negligence

Professional negligence is often called **malpractice**. A professional's duty of care is usually a duty to exercise the degree of care, skill, diligence, and knowledge commonly possessed and exercised by a reasonable, careful, and prudent professional of the same type in the state (or sometimes in the community). Along with attorneys and health care providers, the following professionals might be sued for malpractice: accountants, architects, engineers, surveyors, insurance brokers, real estate agents and brokers, and clergy.

For negligence, the usual kind of damages recoverable are **compensatory**, or money to compensate for the injuries/damages incurred to make the person **whole** (e.g., money for medical bills, lost wages, loss of future earning capacity, pain and suffering, emotional distress, property damage, etc.).

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5.E: Assessment Questions

1. Explain White Collar Crime.

Answer

White collar crimes are characterized by deceit, concealment, or violation of trust. They are committed by business professionals. They generally involve fraud, and the employees committing the crimes are motivated by the desire for financial gains or fear of losing business standing, money, or property. Fraud is the intentional misrepresentation of material facts for monetary gain. This type of crime is not dependent on threats or violence.

2. What is a pump-and-dump scheme?
3. The crime of larceny includes:
    a. The nontresspassory taking and controlling of personal property.
    b. The trespassory taking and carrying away of real or personal property.
    c. Joyriding.
    d. The trespassory taking and control of personal property.

Answer

d

4. Distinguish between larceny and embezzlement.
5. What is the Foreign Corrupt Practices Act?

Answer

The Foreign Corrupt Practices Act prohibits bribery payments by U.S. companies to foreign government officials with an intent to influence foreign business results. One example of bribery would be a situation in which a pharmaceutical company offers special benefits to individuals who agree to prescribe their medications.

6. Businesses can be charged with crimes.
    a. True.
    b. False.
7. The burden of proof is a criminal case is:
    a. Reasonable suspicion.
    b. Beyond a reasonable doubt.
    c. Preponderance of evidence.
    d. Clear and convincing evidence.

Answer

b

8. Which of the following is a goal of an arraignment?
    a. The defendant is informed of the charge and enters a plea.
    b. Requires the defendant to bear the burden of proof
    c. Begins the inquisitorial system of adjudication.
    d. All of these are correct.
9. The criminal act necessary to commit a crime is known as:
    a. Malice aforethought.
    b. Mens rea.
    c. Subjective fault.
    d. Actus reus.

Answer

d

10. Distinguish between civil and criminal law.

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CHAPTER OVERVIEW

6: The Tort System

6.1: Introduction
6.2: Intentional Torts and Negligence
6.3: Product and Strict Liability
6.4: End Notes
6.E: Assessment Questions

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6.1: Introduction

Learning Objectives

- Explain torts system application to business.



Figure 6.1.1: Introduction (Credit: Free-Photos/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

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6.2: Intentional Torts and Negligence

Civil suits arise from damages suffered by one or more persons or entities at the hands of another person or entity. The damage can happen in a variety of circumstances, and may be intentional or unintentional. Unlike criminal cases, civil suits seek to provide some form of remedy for the loss suffered by an injured party. Civil suits are decided by judges and juries based on the specific situation, especially when violation of **statutes**, or laws, is not in question.

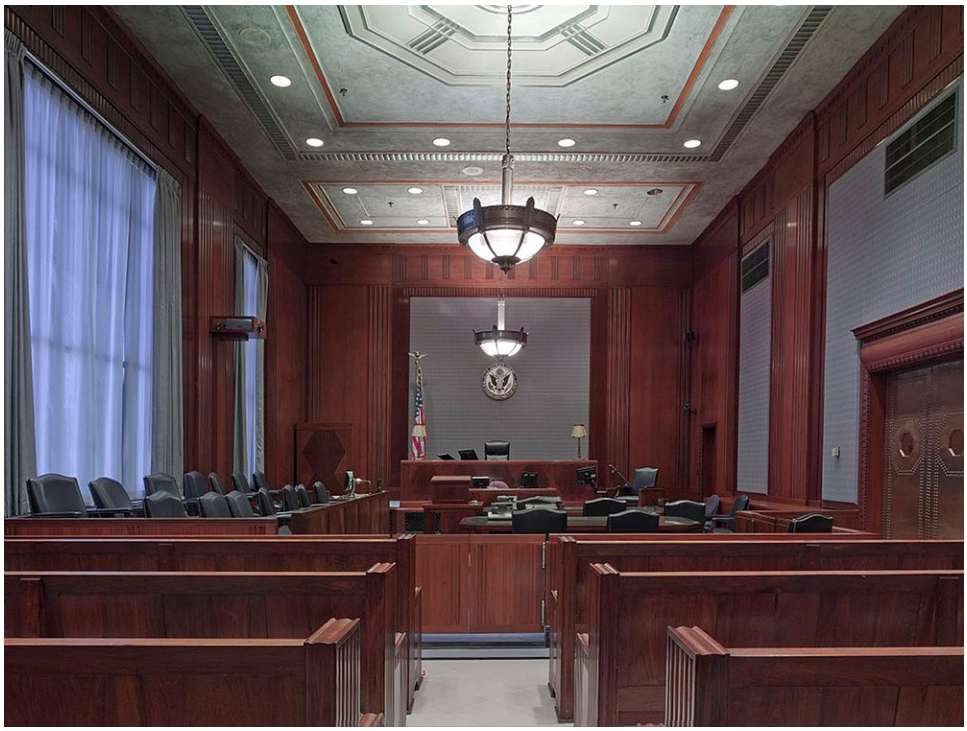


Figure 6.2.1: Civil suits are decided in court by judges and juries. (Credit: Coffee/ pixabay/ License: CC0)

Torts

Civil suits involve different causes of action, and they are included in one general classification: **torts**. The word “tort” means “wrong” in French. Thus, torts are wrongs committed against others who suffer some form of damage as a result. While these damages could also be the result of criminal action, the criminal element of the matter is not tried in a civil lawsuit. The standard of proof is lower for civil suits, and a finding of liability in a tort case does not necessarily translate to guilt in a criminal case.

The actor of the wrongs has historically been called a **tortfeasor**. When a wrong is committed by a tortfeasor, damage is done to another. **Tort law** seeks to address this damage based on the circumstances of the issue, which is based on **fault**. Civil lawsuits are used by the injured parties to seek redress for the loss associated with the tort. Unlike criminal proceedings, redress is often provided in the form of money as opposed to incarceration. As such, the burden of proof of fault is lower. The **offender**, or tortfeasor, who commits the act is the accused in a civil suit. The **plaintiff**, who is the injured party, files the lawsuit on which the civil court will make a decision. The offender ultimately becomes the **defendant**, who must respond to the accusations of the plaintiff in a civil suit.

During tort litigation, the judge and jury have certain separate functions (Kionka, 2013):

Table 6.2.1: Functions During a Tort Litigation

The Judge Decides Issues of Law	The Jury Decides Questions of Fact
The duty of the defendant to the plaintiff, if any	What happened
The elements of the defense	Legal consequences of what happened
Application of legal rules	The damages suffered by the plaintiff

Harm

Two types of torts are intentional torts and negligence. **Intentional torts** occur as the result of a conscious and purposeful act. **Negligence** occurs when an individual does not exercise duty of care. Torts are acts or omissions that result in injury or **harm** to an individual in such a way that it leads to a civil wrong that occurs as liability (WEX, n.d.). In tort law, harm can be defined as a loss or disadvantage suffered as a result of the actions or omissions of another (WEX, n.d.). This loss can be physical harm, such as slipping and falling on a wet floor, or personal property harm, such as allowing water to ruin furniture. The damage is the result of what someone else did, or did not do, either intentionally or based on a lack of reasonable care.

There are two basic elements to torts: damages and compensation (Laws, tort.laws.com). Tort law acts to compensate persons who have suffered damages at the hands of another (Baime, 2018). Tort law determines the legal responsibility of the defendant and the value of the harm. Different types of torts look at different types of circumstances.

Intentional Torts

Intentional torts are committed by an offender who understands that he or she is committing a tort. Intent does not always equate to directly causing an end result. In some cases, the intent may be something else, such as the possession of knowledge that some harm may occur. The harm may result from intentional action, or due to some circumstance that the offender feels will be excusable (Kionka, 2013).

Some circumstances that could allow the defendant to argue that the action is excusable would include: permission by the injured party, or defense of property, self, or another person (Kionka, 2013). If the injured party agrees to allow the defendant to juggle knives and one slips and causes harm, the action might be excusable to some extent. If a defendant caused harm to the plaintiff's car while trying to avoid being hit by the car, it would likely be excusable.

Different types of intentional torts are based on different circumstances and face different **remedies**, or means of recovering losses (Baime, 2018):

- **Assault** is an intentional tort that occurs when an individual has a reasonable apprehension of an intentional act that is designed to cause harm to himself or herself, or to another person.
- **Malicious prosecution** occurs when an individual files groundless complaints to initiate a criminal matter against another.
- **Defamation** occurs when an individual intentionally creates and promotes malicious falsehoods about another. Defamation can occur in two ways: slander and libel. **Slander** is, in effect, when falsehoods are spoken. **Libel** occurs when falsehoods are expressed in written or other recorded forums.
- **Invasion of privacy** involves unwanted production of negative public information. Different standards apply to invasion of privacy based on the status of the individual as a public figure.

Negligence

Negligence is another type of tort that has two meanings. It is the name of a **cause of action** in a tort, and it is a form of conduct that does not meet the **reasonable standard of care** (Kionka, 2013). The cause of action is the reason for the damage, and the standard of care is based on the care that a reasonable person would need in a given situation. Negligence is decided by determining the duty of the defendant, whether or not the defendant committed a breach of that duty, the cause of the injury, and the injury itself.

For an action to be deemed negligent, there must be a legal **duty of care**, or responsibility to act, based on the reasonable standard in a situation (Baime, 2018). An individual can be considered negligent if he agreed to watch a child, but did not do so, and then harm came to the child. An individual would not be considered negligent if he did not know that he was supposed to watch the child, or did not agree to watch the child.



Figure 6.2.2: If an individual agrees to watch a child and the child is injured while that person pays attention to her cell phone, it would be considered negligence. (Credit: JESHOOTScom/ pixabay/ License: CC0)

A **reasonable person** is defined as someone who must exercise reasonable care based on what he or she knows about the situation, how much experience he or she has with the situation, and how he or she perceives the situation (Kionka, 2013). In some cases, this knowledge could be based on common knowledge of community matters, such as knowing that a bridge is closed for repairs.

In some cases, the duty of care is based on a **special relationship**, which is a relationship based on an implied duty of care. This implied duty of care often comes about as a **duty to aid**, or a duty to protect another, e.g., a nurse caring for patients in a hospital, or a lifeguard being responsible for swimmers in the guarded area (Baime, 2018). A passerby does not have a duty to aid, but if the individual tries to help, then he or she is responsible for acting responsibly.

The elements of a negligence cause of action are (Kionka, 2013):

- A duty by the defendant to either act or refrain from acting
- A breach of that duty, based on a failure to conform to the standard of care by the defendant
- A causal connection between the defendant's action or inaction, and the injury to the plaintiff
- Measurable harm that can be remedied in monetary damages

Foreseeability

Negligence case decisions are influenced by whether or not a defendant could have predicted that an action or inaction could have resulted in the tort, or **foreseeability** (Baime, 2018). Responsibility is often based on whether or not the harm caused by an action or inaction was **reasonably foreseeable**, which means that the result was fairly obvious before it occurred (Baime, 2018). A person assisting an inebriated individual into her car could be considered negligent due to the likelihood that harm would come to her while she is driving in an intoxicated state. This situation is an example of the **foreseeable probability of harm**.

Conclusion

Intentional torts and negligence arise based on intentional and unintentional acts committed by individuals. Damages are decided in civil courts by first determining fault and harm, and then by assigning a remedy. Sometimes, the damage can be excused if the

circumstances indicate that the defendant acted with permission, or in his or her own defense. The main standard used to make a decision is the reasonable standard of care: what would a reasonable person do?

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6.3: Product and Strict Liability

Determination of fault and damages for intentional torts and negligence are based on the reasonable standard of care. Another form of torts looks at liability without fault, or **strict liability**. Strict liability determines liability, or harm, based on reasons other than fault (CCBC Legal Studies, n.d.). The mistakes leading to harm can be completely unintentional, and in some cases, unavoidable. Yet, damage is done, and a civil suit arises.

Strict Liability

Strict liability provides a remedy when harm is suffered through no intentional fault. The courts needed to create a standard that would cover this form of tort, or one without fault. The courts came up with the **abnormally dangerous activity standard**, which assigns responsibility when an individual engages in some form of dangerous activity, even if care is taken to avoid mishap (CCBC Legal Studies, n.d.). If a homeowner has horses in a pasture that is bounded by electric fencing, it can be determined that the homeowner exercised reasonable care. However, suppose that the electricity goes down, the horses get out onto the road, and an accident occurs as a result. In this case, the owner is responsible, even though he took reasonable care and the event was unforeseen.



Figure 6.3.1: If horses get out of a fenced-in area, the owner would be liable for any damage they cause while loose. (Credit: Slack/ pexels/ License: CC0)

For a court to assign strict liability based on abnormally dangerous activities, the activity must meet certain criteria. The court must establish that at least four of the following six factors are present (CCBC Legal Studies, n.d.):

- The activity poses a high degree of risk of harm to a person, the land of another, or the property owned by another.
- The harm resulting from this activity would likely be substantial.
- The use of reasonable care would not eliminate this risk.
- The activity is not something that would be considered a matter of common usage.
- The activity is not appropriate for the place where it occurs.
- The danger of the activity overshadows the benefit it poses to a given community.

In essence, the basis for determining strict liability is the extent of the risk involved in the activity. This basis could also apply to the ownership of dangerous pets. A dog that is known to be aggressive would qualify the owner for strict liability should it get out and bite someone. The courts would find that the owner knew, or should have known, that the dog was dangerous and had a propensity to cause harm (Kionka, 2013).

Trespass

In some situations, the owner of the dangerous activity might not be held liable. One such situation is trespassing. Trespassing occurs as an individual enters or remains upon property owned by another without permission (Kionka, 2013). In the case of trespassing, the owner of the property does not have a duty to make the premises safe based on reasonable care for the trespasser (Kionka, 2013). Also, the owner does not have a responsibility to cancel or alter activities on the premises to avoid endangering the trespasser (Kionka, 2013).



Figure 6.3.2: Train tracks are a common area for trespassing. (Credit: Muscat_Coach/ pixabay/ License: CC0)

In some cases, however, the property owner could be held liable (Kionka, 2013):

- When the area in question is a common place for trespassing
- When the owner knows a trespasser is present
- When the trespasser needs aid, then the owner has a duty to rescue him or her
- When the trespasser is a child, and the dangerous activity is deemed as an **attractive nuisance**, or an attraction that a reasonable child would wish to view

Even though trespassing can present an exception to liability in the presence of a dangerous activity, it is not a given. There are numerous exceptions that allow for liability. In effect, strict liability can occur in a given situation even when the property owner has provided care that goes above and beyond what is reasonable. The court does not need to establish proof of lack of due care when applying strict liability to a case (Baime, 2018).

Product Liability

Individuals are not always the defendants involved in civil suits. Manufacturers, wholesalers, distributors, and retailers can also be named in torts that pertain to products and qualify as strict liability (CCBC Legal Studies, n.d.). Some products contain flaws that

were not intentionally created; such flaws may not be discovered until an individual suffers harm as a result of using them.

It is not always possible to conclusively prove that an act or omission was responsible for the harm (Baime, 2018). As a result, the courts developed the doctrine of **res ipsa loquitor**, which means that whatever it is speaks for itself. The burden of proof shifts from the plaintiff to the defendant, who must disprove negligence. However, the plaintiff must first establish three factors (Baime, 2018):

- The defendant had control over the product in question while it was being manufactured.
- Under normal use and circumstances, the product would not cause damage or harm, but damage or harm has occurred in the case in question.
- The behavior of the plaintiff did not significantly contribute to the harm caused.

The doctrine of res ipsa loquitor does not establish proof of negligence, but it does allow the jury to infer what is not explicitly available pertaining to negligent acts or omissions on the part of the defendant (Baime, 2018).

Negligence can occur when products are created because defects can harm consumers. Think about the potential harm that would occur if brake manufacturers were negligent. This negligence would cause brakes to have flaws, which would prevent them from doing their job of stopping cars. If a car does not stop, people will likely be injured. The manufacturing defect would result in a product liability lawsuit, based on legal responsibility for the harmful consequences proximately caused by the product defect (Baime, 2018). Since the courts would not be able to see the negligence occurring, the courts would base their decision on res ipsa loquitor and the fact that the brakes would not normally fail under normal use by the driver.



Figure 6.3.3: If brakes do not work like they are supposed to, it could be the result of a manufacturing defect that would result in product liability. (Credit: Valtercirillo/ pixabay/ License: CC0)

The Unreasonably Dangerous Product Standard

In the case of product liability, the court uses an unreasonably dangerous product standard to determine liability. The unreasonably dangerous product would be so dangerous that the danger would be beyond the expectation of the user, and a less dangerous option could have been produced instead (Kionka, 2013). This type of unreasonably dangerous product often falls into one of three categories (Kionka, 2013):

- A flaw in the manufacturing process that occurred because the manufacturer failed to exercise proper care during manufacturing
- A defect in the design of the product, which makes it dangerous, and safer alternatives are available and economically feasible

- The product includes insufficient warnings or instructions for the proper use of the product and its potential dangers

Defenses

There are defenses to product liability claims. In some cases, the plaintiff's own behaviors contribute to his or her injuries, based on his or her own negligence. This situation is known as **contributory negligence**. Contributory negligence, when determined by the court, prevents any recovery of damages by the plaintiff (Baime, 2018). So, if the court finds contributory negligence, the plaintiff is unable to recover any damages for the injury. Two forms of contributory negligence are assumption of risk and misuse.

Assumption of risk is one defense. In some cases, the defendant can argue that the user assumed the risk of using the product if he or she used the product while knowing that the defect in the product created a risk (CCBC Legal Studies, n.d.). An individual who purchases a saw and sees that the guard is too small to cover the teeth, but decides to use it anyway, is assuming the risk of using the product. If the saw cuts the individual, then the manufacturer could argue that the person assumed the risk because he saw the defect, understood the risk, and used the saw anyway.

Another defense is product **misuse**. In some cases, an individual will use a product in ways that it is not meant to be used (CCBC Legal Studies, n.d.). The user might not be aware of a defect, and he or she proceeds to use the product incorrectly. Misuse by the individual would be to blame for any resulting harm.



Figure 6.3.4: Using a chainsaw with bare feet could be dangerous and add to the risk of use without a guard. If the plaintiff suffered harm because his bare foot could not hold the wood down properly, he could be responsible for comparative negligence. (Credit: edman_eu/ pixabay/ License: CC0)

Plaintiffs might also be responsible for **comparative negligence**. With comparative negligence, the plaintiff's own actions in the use of the product contributed to the harm caused by the product, but the plaintiff might still receive damages (CCBC Legal Studies, n.d.). The amount of negligence on behalf of each part (plaintiff and defendant) is compared to determine the damages to which the plaintiff is entitled (Baime, 2018). If a plaintiff is found to be 30% responsible, and the defendant 70% responsible, then the plaintiff would be entitled to 70% of the damages suffered.

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6.E: Assessment Questions

1. Define Torts.

Answer

Torts are wrongs committed against others who suffer some form of damage as a result.

2. An example of an intentional tort is:
    a. Defamation.
    b. Assault.
    c. Malicious prosecution.
    d. All of the above.
3. When an individual creates and promotes malicious falsehoods about another that individual may be liable for:
    a. Libel.
    b. Slander.
    c. Defamation.
    d. All of the above.

Answer

d

4. Describe Negligence.
5. All of the following are elements of negligence except:
    a. A reasonable person.
    b. A duty by the defendant to either act or refrain from acting.
    c. A breach of a duty owed by defendant.
    d. Measurable harm.

Answer

a

6. Which of the following is a special relationship giving rise to a duty to act to aid or protect one in peril?
    a. Hotel and guest.
    b. Cousin to cousin.
    c. School principal and student.
    d. Hotel and guest, and school principal and student.
7. If an activity causes a foreseeable and highly significant risk of physical harm even when reasonable care is exercised by all actors, and the activity is not one of common usage, it is:
    a. Proximate cause.
    b. Abnormally dangerous.
    c. Negligence.
    d. None of these are correct.

Answer

b

8. What is an attractive nuisance?
9. The elements of res ipsa loquitor that a plaintiff must establish in a product liability lawsuit include all of the following except:
    a. The defendant breached his or her duty of care.
    b. The defendant had control over the product in question while it was being manufactured.

c. Under normal circumstances, the product would not cause damage or harm, but damage or harm has occurred in the case in question.
d. The behavior of the plaintiff did not significantly contribute to the harm caused.

Answer

a

10. Describe the differences between contributory and comparative negligence.

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CHAPTER OVERVIEW

7: Contract Law

7.1: Introduction
7.2: Consideration and Promissory Estoppel
7.3: Capacity and Legality
7.4: Breach of Contract and Remedies
7.5: End Notes
7.E: Assessment Questions

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7.1: Introduction

Learning Objectives

- Analyze the principles of contract law and how they apply to businesses.



Figure 7.1.1: Introduction (Credit: edar/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

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7.2: Consideration and Promissory Estoppel

A contract is defined as an agreement between two or more parties that is enforceable by law.

To be considered enforceable by law, a contract must contain several elements, including offer and acceptance, genuine agreement, consideration, capacity, and legality.



Figure 7.2.1: Before a contract can become legal and enforceable, several elements must first be in place. (Credit: rawpixel/ pixabay/ License: CC0)

The key to a contract is that there must be an offer, and acceptance of the terms of that offer. An offer is a proposal made to demonstrate an intent to enter a contract. Acceptance is the agreement to be bound by the terms of the offer. Offers must be made with intent, must be definite and certain (i.e., the offer must be clearly expressed for it to be enforceable), and must be communicated to the offeree. An acceptance must demonstrate the willingness to consent to all of the terms of the offer.

Genuine agreement, i.e., “a meeting of the minds,” is also required. Agreement can be destroyed by fraud, misrepresentation, mistake, duress, or undue influence.

Consideration must be included in contracts. Consideration is a thing of value promised in exchange for something else of value. This mutual exchange binds the parties together.

Capacity to contract is the next element required for a valid agreement. The law presumes that anyone entering a contract has the legal capacity to do so. Minors are generally excused from contractual responsibility, as are mentally incompetent and drugged or drunk individuals.

Finally, legality is the last element considered. Parties entering into contracts that involve illegal conduct may not expect judicial relief to have that contract enforced. This theory has also been applied to conduct that would be considered in opposition to public policy.

Consideration and Promissory Estoppel

Contract law employs the principles of consideration and promissory estoppel.

Consideration

In most cases, consideration need not be pecuniary (monetary). Most contracts are enforceable only if each party gets consideration from the agreement. Consideration can be money, property, a promise, or some right. For instance, when a music company sells

studio equipment, the promised equipment is the consideration for the buyer. The seller's consideration is the money the buyer promises to pay for the equipment.

Promissory Estoppel

The promissory estoppel doctrine is an exception to the requirement of consideration for contracts. Promissory estoppel is triggered when one party acts on the other party's promise. In cases where it is triggered, there is harm or severe injustice to the party who acted because they relied on the other party's broken promise.

The doctrine of promissory estoppel allows aggrieved parties to pursue justice or fairness for the performance of a contract in court, or other equitable remedies, even in the absence of any consideration. Its legal application may vary from state to state, but the basic elements include:

- A legal relationship existed between the parties.
- A promise was made.
- There was reliance on the promise that caused one party to act before any real consideration was exchanged.
- A substantial and measurable detriment occurred as a result of the failure to perform on the contract.
- An unconscionable result, or gross injustice, resulted from the broken promise.

If it is found that these elements are satisfied and that the doctrine of estoppel is applicable, then the court will issue the appropriate damages in the form of reliance damages to restore the aggrieved party to the position they were in prior to the broken promise. Expectation damages are not usually available if promissory estoppel is being claimed.

An example of how this principle would apply is:

Example 7.2.1: promissory estoppel

After a bidding war for his services, Bob turns down a job offer with We are the Best, LLC in Miami, Florida (where he lives), and accepts a dream job offer from MegaCorp Co. in San Francisco, California. The offer contains a specific start date, compensation terms, benefits outline, and more. However, it does not include relocation expenses or provisions. The company is aware of his plans to move across the country for the sole purpose of taking this dream role. Bob breaks his Miami lease with penalty and spends approximately $13,000 in moving and travel costs. As the cost of living in San Francisco is much higher than in Miami, he puts down a much pricier first and last month's rent and security deposit payment than he is used to. Within two days of his planned start date, he receives a call from management at MegaCorp Co. stating that the company has changed its mind and decided to go in a different direction. If Bob brings a promissory estoppel suit, he will likely be entitled to all of the costs that he incurred while anticipating the start of the promised role (i.e., penalty for the broken lease, moving costs, difference in the rental costs, cost of breaking the new lease, if necessary, etc.) Following reimbursement of his costs, Bob will be returned to the same position he was in prior to the broken promise. However, the company will not likely be required to reopen the role for him or give him the job, as originally anticipated. Also, he will not likely be awarded any damages for the job that he turned down with We are the Best, LLC, as expectation damages are not usually available.

The doctrines of consideration and promissory estoppel are essential to an understanding of how contracts are formed and enforced in the United States.

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7.3: Capacity and Legality

For a contract to be legally binding, the parties entering into the contract must have the **capacity** to do so. As a legal matter, there are certain classes of people who are presumed to have no capacity to contract. These include legal minors, the mentally ill, and those who are intoxicated. If people meeting these criteria enter into a contract, the agreement is considered voidable. If a contract is **voidable**, then the person who lacked capacity has the choice to either end the contract or continue with it as agreed upon. This design is meant to protect the party lacking capacity.

Following are some examples of the application of these rules.

Minors Have No Capacity to Contract

In most states, minors under the age of 18 lack the capacity to make a contract and may therefore either honor an agreement or void the contract. However, there are a few exceptions to this rule. In most states, a contract for necessities (i.e. food and clothing) may not be voided. Also, in most states, the contract can no longer be voided when the minor turns 18.

Example 7.3.1

Mary, 16, an athlete, signs a long-term endorsement deal with a well-known brand and is compensated for several years. At age 20, she decides she wants to take a better endorsement deal, so she tries to void the agreement on the grounds that it was made when she was a minor and that she lacked capacity at that time. Mary will not likely succeed in having her agreement voided, as she has passed the period of incapacity.

Mental Incapacity

If a person lacks the mental capacity to enter a contract, then either he or she, or his or her legal guardian, may void it, except in cases where the contract involved necessities. In most states, mental capacity is measured against the "cognitive standard" of whether the party understood its meaning and effect.

Example 7.3.2

Mr. Williams contracted to sell a patent. Later, however, he claimed that he lacked capacity to enter the agreement. He, therefore, sought to have the contract voided. Williams based his claim on the fact that he had been diagnosed as manic-depressive and had received treatment from a variety of mental hospitals for this condition. His doctor stated that he was unable to properly evaluate business opportunities and contracts while in a "manic" state. A California Court of Appeals, evaluating a similar situation, refused to terminate the contract and stated that even in his manic state, the party was capable of contracting, as his condition may have impaired his judgment but not his understanding of the contract. With other mental conditions, a different legal conclusion could be reached.

Voluntary Intoxication – Drugs and Alcohol

Courts generally do not find lack of capacity to contract for people who are voluntarily intoxicated. The rationale for this decision is found in the reasoning that individuals should not be allowed to side-step their contractual obligations by virtue of their self-induced states. By another token, however, courts also seek to avoid the undesirable result of allowing the sober party to take advantage of the other person's condition. Therefore, if a party is so inebriated that he or she is unable to understand the nature and consequences of the agreement, then the contract may be voided by the inebriated party.

Example 7.3.3

In the late 1900s, the owner of a significant amount of stock went on a three-month drinking binge. A local bank that was aware of his consistent inebriation hired a third party to contract with him. The third party succeeded in getting him to sell his stock for about 1.5% of the worth of its total value. When the duped seller ended his binge a month later, he learned that the third party had sold the stock to the local bank behind the deal. He then sued the third party. Ultimately, the case was decided by the U.S. Supreme Court, which found that the agreement was void because both the bank and the third party knew that the

plaintiff was unaware of what he was doing when he entered the contract. The bank was required to return the shares to the plaintiff, minus the 1.5% amount of real value that he had been paid for the shares.

Legality

Contracts must be created for the exchange of legal goods and services to be enforced. An agreement is void if it violates the law, or is formed for the purpose of violating the law. Contracts may also be found voidable if they are found violative of public policy, although this is rarer. Typically, this conclusion is only invoked in clear cases where the potential harm to the public is substantially incontestable, eluding the idiosyncrasies of particular judges.

For a contract to be binding, it must not have a criminal or immoral purpose or go against public policy. For example, a contract to commit murder in exchange for money will not be enforced by the courts. If performing the terms of the agreement, or if formation of the contract, will cause the parties to engage in activity that is illegal, then the contract will be deemed illegal and will be considered void or "unenforceable," similar to a nonexistent contract. In this case, there will not be any relief available to either party if they breach the contract. Indeed, it is a defense to a breach of contract claim that the contract itself was illegal.

Example 7.3.4

In a state where gambling is illegal, two parties enter into an employment contract for the hiring of a blackjack dealer. The contract would be void because the contract requires the employee to perform illegal gambling activities. If the blackjack dealer tries to recover any unpaid wages for work completed, his claim will not be recognized because the courts will treat the contract as if it never existed.

By contrast, parties enter a contract that involves the sale of dice to a known dealer in a state where gambling is unlawful. The contract would not be considered void because the act of selling dice, in and of itself, is not illegal.

Some examples of contracts that would be considered illegal are contracts for the sale or distribution of illegal drugs, contracts for illegal activities such as loansharking, and employment contracts for the hiring of undocumented workers.

An understanding of the several theories outlined herein for establishing (or challenging) capacity and legality in contract law is essential to this area of law.

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7.4: Breach of Contract and Remedies

Once a contract is legally formed, both parties are generally expected to perform according to the terms of the contract. A breach of contract claim arises when either (or both) parties claim that there was a failure, without legal excuse, to perform on any, or all, parts and promises of the contract.

Several inquiries are triggered when a breach of contract claims is initiated. The first step is to determine whether a contract existed in the first place. If it did, the following questions may be asked: What did the terms of the contract require of the parties? Were the contractual terms modified at any point? Did the breach actually occur? Was the claimed breach material to the contract? Does any legal excuse or defense to enforcement of the contract exist? What damages were caused by the breach?

Material vs. Minor Breach

The parties' obligations and remedies for a breach of contract depend on whether the breach is considered material or minor.

When something substantially different from what was expected under the terms of the contract is delivered, the breach will be considered material. For example, the breach will be considered material if the contract promises the delivery of Christmas ornaments, but the buyer receives a box of candies. In the case of a material breach, the non-breaching party has the right to all remedies for breach of the entire contract and is no longer expected to perform their obligations. In considering whether a breach is material, courts will determine whether the non-breaching party still received a benefit, and if so, how much was received, adequate compensation for the damages, the extent of the performance (if any) by the breaching party, any hardship to the breaching party, the negligence or intent behind the behavior of the breaching party, and finally, the possibility that the breaching party will perform the remainder of the contract.

There are times, however, that despite the breaching party's failure to perform some of the contract, the other party still receives a majority of the goods or services specified in the contract. In this case, the breach will be considered minor. For example, the breaching party may be late on delivering goods or services promised under a contract that does not specify a firm delivery date and that doesn't state that time is of the essence. In this case, a reasonably short delay would likely only be considered a minor breach of the contract. Consequently, the non-breaching party would still be required to perform as pursuant to the contract. However, damages may be available to them if they suffered some harm as a result of the delay.

Remedies

Typically, the remedies that will be available if a breach of contract is found are money damages, restitution, rescission, reformation, and specific performance.



Figure 7.4.1: When there is a breach of contract, the courts might get involved to help determine the remedy. (Credit: succo/ pixabay/ License: CC0)

Money damages include compensation for financial losses caused by the breach.

Restitution restores the injured party to status quo or the position they had prior to the formation of the contract, by returning to the plaintiff any money or property given pursuant to the contract. This type of relief is typically sought when a contract is voided by courts due to a finding that the defendant is incompetent or lacks capacity.

Rescission or reformation may be available to parties who enter into contracts by mistake, fraud, undue influence, or duress. Rescission terminates the duties of both parties under the contract, while reformation allows courts to equitably change the contract's substance.

Specific performance compels one party to perform the promises stated in the contract as nearly as practicable. Specific performance is only mandated when money damages do not adequately compensate for the breach. Personal service, however, may not be used to compel specific performance, since doing so would constitute forced labor, i.e. slavery, which is in violation of the U.S. Constitution.

Inevitably, when valid contracts are created, the potential for breach exists. An understanding of what happens when a contract's terms are breached is fundamental to an understanding of contract law.

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7.E: Assessment Questions

1. What is the definition of a contract?

Answer

A contract is defined as an agreement between two or more parties that is enforceable by law.

2. The elements of a contract include all but the following element:
    a. Offer and acceptance.
    b. Consideration.
    c. Capacity.
    d. Promissory Estoppel.
3. What are the ways an agreement can be invalidated?
    a. Fraud.
    b. Misrepresentation.
    c. Undue influence.
    d. All of the above.

Answer

d

4. Describe the concept of Promissory Estoppel.
5. Consideration may include any of the following except:
    a. A promise.
    b. A gift.
    c. Property.
    d. Money.

Answer

b

6. What happens when a person lacks the legal capacity to enter into a contract?
7. Which of the following is most likely to be classified as a necessity for which a minor will be held liable on a contract?
    a. A television.
    b. School supplies.
    c. Education.
    d. Food.

Answer

d

8. A minor can avoid a contract to purchase a car if:
    a. The car has been destroyed.
    b. The car has been damaged.
    c. He or she grows tired of it.
    d. All of the above.
9. When can a mentally incompetent person void a contract?

Answer

If a person lacks the mental capacity to enter a contract, then either he or she, or his or her legal guardian, may void it, except in cases where the contract involved necessities. In most states, mental capacity is measured against the “cognitive standard” of whether the party understood its meaning and effect.

10. Examples of illegal contracts include all but the following:
    a. Contracts for the sale or distribution of heroin.
    b. Contracts for loansharking.
    c. Contracts in consideration of marriage.
    d. Employment contracts for the hiring of undocumented workers.
11. Define a material breach.

Answer

A material breach is when something substantially different from what was expected under the terms of the contract is delivered, the breach is considered material.

12. Typical remedies available for a breach of contract include:
    a. Money damages.
    b. Rescission.
    c. Specific Performance.
    d. All of the above.
13. Distinguish between rescission and reformation.

Answer

Rescission terminates the duties of both parties under the contract, while reformation allows courts to equitably change the contracts substance.

14. Courts of equity will not grant specific performance of contracts:
    a. For a personal service contract.
    b. For the sale of real estate.
    c. For the sale of the original manuscript of a rare edition book.
    d. All of these are correct.
15. Define restitution.

Answer

Restitution restores the injured party to status quo or the position they had prior to the formation of the contract, by returning the plaintiff any money or property give pursuant to the contract.

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CHAPTER OVERVIEW

8: Sales Contracts

8.1: Introduction

8.2: The Nature and Origins of Sales Contracts

8.3: Warranties and Sales Contracts

8.4: End Notes

8.E: Assessment Questions

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8.1: Introduction

Learning Objectives

- Recognize nuances of contracts pertaining to sales.



Figure 8.1.1: Introduction (Credit: JESHOOTS-com/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

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8.2: The Nature and Origins of Sales Contracts

Features of Sales Contracts

Commercial enterprises that engage in buying and selling practices need to be aware of the features and nature of **sales contracts**. A contract of sale is a specific type of contract in which one party is obligated to deliver and transfer ownership of a good to a second party, who in turn is obligated to pay for the good in money, or its equivalent. The party who is obligated to deliver the good is known as the **vendor** or seller. The party who is obligated to pay for the good is known as the **vendee** or buyer.

It has generally been established that there are six main features of sales contracts. Sales contracts are:

1. **Consensual**: they are perfected by mere consent without the need for any additional acts
2. **Bilateral**: both parties in the contract are bound to fulfill reciprocal obligations toward each other
3. **Onerous**: the good sold is conveyed in consideration of the price, and the price paid is conveyed in consideration of the good
4. **Commutative**: the good sold is considered to be the equivalent of the price, and vice versa
5. **Nominate**: this type of contract has a special designation (i.e., sale)
6. **Principal**: the validity does not depend upon the existence of other contracts

Sources of Law for Sales Contracts

Only in very limited circumstances (such as in the buying and selling of stocks) does federal law govern sales contracts. Until the 1950s, there were two main sources of law for sales contracts: state common law and state statutory law. Thus, the laws governing sales contracts differed from state to state. As interstate commercial activity grew in importance, there was a need for a uniform law for sales transactions that would harmonize rules across the states. Therefore, in 1952, the Uniform Commercial Code (UCC)was created to govern business transactions. All 50 states have adopted the Code, but each has the power to modify it, in line with the wishes of the state legislature.

The Uniform Commercial Code

The UCC categorizes items that can be bought or sold into three types:

1. **Goods** are defined in Section 2-105 of the UCC as tangible items "which are movable at the time of identification to the contract for sale." Therefore, the primary features of goods are that they are movable and tangible. Refrigerators, paper, and furniture are all examples of goods.
2. **Services** are items that are movable but not tangible. Accounting is an example of a service.
3. **Realty** describes non-good items that are tangible but not movable. Under this definition, commercial and residential property are classed as realty.

These definitions have created some grey areas that have been clarified by the courts in their interpretation of the UCC. In the 2008 case *Crown Castle Inc. et al. v. Fred Nudd Corporation et al.*, a case in which the telecommunications company Crown Castle sued a cell phone tower installation firm for the construction of faulty towers, the courts had to determine whether cell phone towers (monopoles) should be classified as movable (and hence goods) or non-movable (and therefore realty). Ultimately, it was determined that monopoles are goods. Items that are attached to realty (e.g. a counter or a bar) and that are used for business activities are described as **trade fixtures** and treated as goods. Software licenses are not tangible, but they are also not movable, and have been treated in different ways: as goods, a **mixed sale** (a tangible item tied to an intangible item), and pure services. Items such as soil and clay may be treated as goods even if they are part of immovable land because they can be extracted and moved. Crops that are sold while they are still growing on the land are also considered to be goods even though they are technically immovable while growing.

Article 2 of the UCC specifically pertains to sales contracts of goods. It defines a sale as a transaction that involves "the passing of title from the seller to the buyer for a price." However, **merchants** are classified as a separate entity under the terms of the UCC. This distinction is important because the Code contains provisions that specifically apply to merchants and place greater duties on merchants to protect private citizens. There are four ways in which an entity can be classified as a merchant:

Table 8.2.1

Classification	Examples
An agent who regularly sells goods as part of his or her business or trade	A seller on an online auction site
An individual who employs other people to sell goods	The owner of a clothing store
A person who works for a person who sells goods	An employee at a grocery retailer
Any entity who self-identifies as a merchant	An individual who describes himself or herself as a merchant in corporate documents

Formation of Sales Contracts under the UCC

Sales contracts require most of the same components as general contracts, but the UCC includes some provisions that specifically pertain to the creation of sales contracts. First, the UCC includes a new category of **offer**. Basic contract law states that for an offer to be valid, it has to have "definiteness of terms." In the UCC, most of that particular rule is modified for greater flexibility. If the parties have "open" (in other words, "not definite") terms, the UCC addresses the situation with an overlay of "reasonableness"—for example, if no time for performance is designated, the performance must occur within a "reasonable" time. As a result, the following terms are legally allowed to be "open," and there is a "default" provision that will apply under the UCC:

Table 8.2.2

Open Term	Default	Applicable UCC Provision
Price	If price is not named, the default is "reasonable price."	UCC 2-305(1)
Payment	If payment is not named, default is "due at the time and place at which the buyer is to receive the goods."	UCC 2-310(a)
Delivery	If delivery is not named, the default is "buyer normally takes delivery at the seller's place of business."	UCC 2-308(a)
Duration of an Ongoing Contract	If duration of an ongoing contract is not named, the default is "buyer normally takes delivery at the seller's place of business."	UCC 2-308(a)

The only term that really cannot be left open is the **quantity** term. The court is not going to second-guess a quantity if the parties don't set one in the contract—for example, why would the court arbitrarily want to force the parties to buy and sell $15,000$ widgets if a quantity wasn't specified? There are two exceptions to this rule: **requirements contracts** ("as much as I need") and **output contracts** ("as much as you can produce"). Even though these ideas are **illusory**, they're generally allowed in the commercial setting with good-faith limitations under UCC 2-306.

Sometimes, however, the courts will not allow purported "requirements" contracts. In one case, a court ruled that the contract was an unenforceable illusory contract instead of an enforceable requirements contract, even though it was a contract for the sale of goods ("as much as I need"). The reason for this ruling was that it did not appear that the buyer had any real intention of going through with any purchase.

Under Section 2-205 of the UCC, offers made by merchants are considered to be **firm offers** if the offers are made in writing and explicitly state that there is a three-month irrevocability period. A three-month irrevocability period is assumed if no mention is made with the offer. **Acceptance** of the offer can be made in any reasonable manner, but the **mirror-image rule** does not apply under the UCC. This means that if the terms of the acceptance do not mirror those of the offer, the acceptance is treated as a counteroffer and no legal contract is formed. Sale of goods contracts must be in writing if the value of the goods is $\$500$ or more. Modifications to the contract must be made in good faith, and new consideration is not required. A contract provision, or the entire

contract itself, can be considered to be **unconscionable** if its terms are unfair or unreasonable. If a court deems this to be the case, the contract, or certain provisions of it, may be unenforceable.

Title

Title means ownership of a good. When the sale is completed, an agent must pass the title for the good to the buyer. There are three types of titles:

1. **Good title** describes a title that is obtained from an individual who owns the goods free and clear.
2. **Void title** occurs when the title is passed to the buyer from a person who does not legitimately own the title. An important point is that good faith is irrelevant when a void title is acquired. For example, a person who unknowingly purchased stolen goods has a void title. An exception occurs when an owner **entrusts** goods to a merchant who ordinarily deals in those goods, and then that merchant sells the goods to a good-faith buyer. In this case, the buyer acquires a good title. For example, if a motorcycle owner takes the motorcycle to a vehicle repair shop and the motorcycle is accidentally sold, the buyer acquires the title.
3. **Voidable title** occurs when the contract would have been good, but certain circumstances make it voidable. For example, if the buyer was deceitful about his or her true identity, the buyer is a minor, or the buyer wrote a bad check in the sale, then the title is deemed voidable.



Figure 8.2.1: A sale is defined as a transaction that involves the passing of a title from the seller to the buyer for a price. (Credit: Negative Space/ pexels/ License: CC0)

Issues Associated with Title

Imagine the following scenario: A café purchases a new coffee machine from a supplier. However, when the supplier tries to deliver the equipment to the café, it is involved in an accident and the coffee machine is destroyed. A question emerging from this scenario is this: Is the supplier legally obligated to replace the machine? Asked differently: Who holds the good title in this scenario?

Prior to the introduction of the Uniform Common Code, the loss would have fallen on the owner of the café, since he or she paid for the coffee machine prior to taking possession of it. Under the UCC, however, as long as the supplier is considered a merchant, the risk of loss remains with the merchant until the buyer takes possession of the good.

Given problems like the one described above, the UCC separately considers four specific issues relating to titles:

- **Ownership**. Under consideration is the question of when the title transfers from vendor to vendee, and hence when ownership is said to occur.
- The concept of **encumbrance** considers when the vendee is granted an interest in the good such that the good can be used as collateral for a debt.
- The UCC considers when the risk of **loss** attaches and what the responsibilities of the buyer and seller are to each other, should a loss occur.
- **Insurable interest** is the right to insure the goods against exposure to risk of loss or damage

The UCC allows four scenarios for sales contracts: simple delivery contracts, common-carrier delivery contracts, goods-in-bailment contracts, and conditional sales contracts.

Each type involves the title, risk of loss, and insurable interest passing at different times.

A **simple delivery contract** occurs when the goods are transferred from the buyer to the seller at the time of the sale or later, e.g., if the goods are delivered. Title transfers when the contract is executed, insurable interest passes at the same time, and risk of loss transfers when the buyer takes possession, unless the seller is not a merchant. In the latter case, under the rule of **tender of delivery**, risk remains with the buyer.

A **common-carrier delivery contract** occurs when a common carrier, who is an independent contractor rather than an agent of the seller (e.g., a trucking line), delivers the goods. The UCC further categorizes these types of contracts into shipment contracts and destination contracts:

1. A **shipment contract** occurs when it is the responsibility of the seller to make the shipping arrangements and to transfer the goods to the common carrier. Under this contract, title passes to the buyer at the time of shipment, so the buyer bears the risk of loss, even when he or she has not taken possession of the goods.
2. A **destination contract** occurs when the seller is required to deliver the goods to a location that is stipulated in the contract. Under this contract, title transfers when the goods are delivered, but the seller bears the risk of loss until that time.

A **goods-in-bailment contract** occurs when the goods are stored under the control of a third party, such as in a warehouse or on a ship. Transfer of title and risk of loss depends on whether the seller has a document indicating ownership of the goods and whether that document is negotiable or non-negotiable. A **negotiable** document contains the words, “deliver to the order of [seller].” As soon as that document is endorsed to the buyer, both title and risk pass to the buyer. A **non-negotiable** document lacks those words. Under these circumstances, title passes with the endorsement of the document, but risk of loss does not pass until the custodian of the goods is notified of the title. If a document of title is completely absent, title passes at the same time as the execution of the contract, but risk does not pass until the custodian is notified of, and acknowledges, the transaction. Insurable interest is created when either the buyer or seller has the title, risk of loss, or an economic interest in the goods.

Finally, a **conditional sales contract** is a contract that occurs when the sale is dependent on approval. For example, a sale-or-return agreement occurs when both parties agree that the buyer can return the goods at a later date. Insurable interest is created once the goods are identified in the contract. Title and risk of loss depend on whether the goods are delivered by the common carrier, the seller, or in bailment, as described above.

The International Sale of Goods

With globalization, there has been a significant expansion of commercial transactions undertaken across international borders. The **United Nations Convention on Contracts for the International Sale of Goods**, or the CISG, is the main legal structure offered for the governance of international commercial transactions. The CISG broadly covers the same topics as the UCC, but it preempts the UCC if there is a problem with an international sale.

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8.3: Warranties and Sales Contracts

Warranties

A **warranty** is a guarantee on the good that comes as part of the sales contract, but contract law treats warranties as an additional form of contract that binds the selling party to undertake a certain action. Typically, the selling party has an obligation to provide a product that achieves a specified task, or to deliver a service that meets certain minimal standards. Warranties are offered for a range of different goods and services, from manufactured goods to real estate to plumbing services. The warranty assures the buyer that the good or service is free from defects, and it is a legally binding commitment. In the event that the product or service fails to meet the standards set out in the warranty, then the contract provides a specific remedy, such as a replacement or repair.



Figure 8.3.1: The law provides remedies for breach of sales contracts. (Credit: rawpixel/ pexels/ License: CC0)

According to UCC 1-203, the performance and execution of all contracts must be undertaken in good faith. **Good faith** means honesty in fact and the observance of reasonable commercial standards of fair dealing. If the parties in the contract are merchants, the UCC also requires that the contract be undertaken in accordance with **commercial reasonableness**. This requirement means that the transaction should be undertaken in a sensible and prudent way.

Express and Implied Warranties

Warranties can be express, implied, or both. Both express and implied warranties provide legal relief for the purchaser in the event of a breach of contract.

An **express warranty** is one in which the seller explicitly guarantees the quality of the good or service sold. Typically, the vendor provides a statement, or other binding document, as part of the sales contract. What this means in practice is that the buyer has engaged in the contract on the reasonable assumption that the quality, nature, character, purpose, performance, state, use, or capacity of the goods or services are the same as those stated by the seller. Therefore, the sales contract is based, in part, on the understanding that the goods or services being supplied by the seller will conform to the description, or any sample, that has been provided.

There are myriad ways in which the seller can make statements as to the characteristics of the goods.

Here are a few examples of express warranties:

“Wrinkle-free shirt”

“Lifetime guarantee”

“Made in the USA”

“This orange juice is not from concentrate”

“24k gold”

There is not a specific way that words must be formed to make an express warranty valid. Importantly, the sales contract does not need to explicitly state that a warranty is being intended. It is enough that the seller asserts facts about the goods that then become

part of the contract between the parties. However, the courts do apply a **reasonableness test of reliance** upon warranties. Puffery, or language used to bolster sales, is lawful, and the consumer is required to apply reason when evaluating such statements. For example, buyers are expected to use reason when judging seller claims such as “this sandwich is the best in the world.” Obvious sales talk cannot ordinarily be treated as a legally binding warranty.

A **breach** of the warranty occurs when the express warranty has been found to be false. In such circumstances, the warrantor is legally liable just as though the truth of the warranty had been guaranteed. The courts do not accept as a defense:

- Seller claims the warranty was true.
- Seller claims due care was exercised in the production or handling of the product.
- Seller claims there is not any reason to believe that the warranty was false.

Implied Warranties

In certain circumstances where no express warranty was made, the law **implies** a warranty. This statement means that the warranty automatically arises from the fact that a sale was made. With regard to implied warranties, the law distinguishes between casual sellers and merchant sellers, with the latter held to a higher standard, given that they are in the business of buying or selling the good or service rendered. For example, unless otherwise agreed, goods sold by merchants carry an implied warranty against claims by any third party by way of trademark infringement, patent infringement, or any other intellectual property law infringement. This type of warranty is known as the **warranty against infringement**. Another implied warranty provided by merchant sellers is the **warranty of fitness for normal use**, which means that the goods must be fit for the ordinary purposes for which they are sold.

It is important to note that if express warranties are made, this does not preclude implied warranties. If an express warranty is made, it should be consistent with implied warranties, and can be treated as cumulative, if such a construction is reasonable. If the express and implied warranties cannot be construed as consistent and cumulative, the express warranty generally prevails over the implied warranty, except in the case of the implied warranty of merchantability, or fitness for purpose.

Breaches of Warranty

If the buyer believes that there has been a breach of the implied warranty of merchantability, it is their responsibility to demonstrate that the good was defective, that this defect made the good not fit for purpose, and that this defect caused the plaintiff harm. Typical examples of defects are:

- Design defects
- Manufacturing defects
- Inadequate instructions on the use of the good
- Inadequate warning against the dangers involved in using the good.

Specific Examples of Goods Under the Warranty of Merchantability

Table 8.3.1

Type	Description
Second-hand goods	The UCC treats warranties arising for used goods in the same way as warranties arising for new goods, but second-hand products tend to be held to a lower standard on the warranty of merchantability.
Buyer-designed goods	The same warranties arise for mass manufactured goods as for goods that have been specified or made to order for the buyer. However, in this case, no warranty of fitness for purpose can arise since the buyer is using his or her own decisions, skill, and judgment when making the purchase.
Food and drink	The sale of food or drink carries the implied warranty of being fit for human consumption.

The buyer might intend to use the goods purchased for a different purpose than that for which it was sold. In this case, the implied warranty holds only if the buyer relies on the seller's skill or judgment to select the product, the buyer informs the seller at the time of purchase of his or her intention for the use of the good, and the buyer relies on the seller's judgment and skill in making the final choice. If the seller is not made aware of the buyer's true intention, or does not offer his or her skill and judgment in aiding the sale, then warranty of fitness for a particular purpose does not arise. For this reason, it is common for vendors to include provisions in the average terms and conditions of sale with regard to the true and intended purpose of use.

Warranty of Title

By the mere act of selling, the vendor implies a warranty that the title is good and that the transfer of title is lawful. In addition, the act of the sale creates a warranty that the goods shall be delivered free from any lien of which the buyer was unaware. In some circumstances, the warranty of title can be excluded from the contract documents. For instance, when the seller makes the sale in a representative capacity (e.g. as an executor of an estate), then a warranty of title will not arise.

Remedies to Buyers under the UCC

Table 8.3.2

Remedy	Description
Cancel the contract	The UCC allows buyers to cancel the contract for nonconforming goods and to seek remedies that give them the benefit of the bargain.
Obtain cover	Buyers are allowed to substitute goods for those due under the sales contract. However, substitutes must be reasonable, acquired without delay, and obtained in good faith.
Obtain specific performance	If the goods are unique or a legal remedy is inadequate, the seller may be required to deliver the goods as identified in the contract.
Sue	Buyers are entitled to consequential and incidental damages if there is a breach of contract. They may also be able to obtain liquidated damages (damages before the breach occurs) or punitive damages.

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8.E: Assessment Questions

1. What is a sales contract?

Answer

A sales contract is s specific type of contract is which one party is obligated to deliver to deliver and transfer ownership of a good to a second party, who in turn is obligated to pay for the good in money, or its equivalent.

2. All of the following are features of sales contracts except:
   a. Consensual.
   b. Bilateral.
   c. Cumulative.
   d. Principal.
3. What source of law governs sales contracts?
   a. Common Law.
   b. The Uniform Commercial Code.
   c. Statutory Law.
   d. Federal Law.

Answer

b

4. What is the definition of a good?
5. Distinguish a shipment contract from a destination contract.

Answer

A shipment contract occurs when it is the responsibility of the seller to make the shipping arrangements and to transfer the goods to the common carrier. Under this contract, title passes to the buyer at the time of shipment, so the buyer bears the risk of loss, even when he or she has not taken possession of the goods. A destination contract occurs when the seller is required to deliver the goods to a location that is stipulated in the contract. Under this contract, title transfers when the goods are delivered, but the seller bears the risk of loss until that time.

6. What is a warranty in a sales contract?
7. Describe the difference between an express and implied warranty.

Answer

An express warranty is one in which the seller explicitly guarantees the quality of the good or service sold. Typically, the vendor provides a statement, or other binding document, as part of the sales contract. In certain circumstances where no express warranty was made, the law implies a warranty. This statement means that the warranty automatically arises from the fact that a sale was made.

8. Examples of a defect in a breach of the implied warranty of merchantability, include all of the following except:
   a. Design defect.
   b. Manufacturing defect.
   c. Inadequate instructions.
   d. Product defect.
9. The following are possible remedies to buyers under the UCC:
   a. Cancel the contract.
   b. Obtain Cover.
   c. Sue.

d. All of the above.

Answer

d

10. What is a breach of warranty?

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CHAPTER OVERVIEW

9: Relationships between Principal and Agent

Learning Objectives

After reading this chapter, you should understand the following:

- Why agency is important, what an agent is, and the types of agents
- What an independent contractor is
- The duties owed by the agent to the principal
- The duties owed by the principal to the agent

9.1: Introduction to Agency and the Types of Agents

9.2: Duties between Agent and Principal

9.3: Cases

9.4: Summary and Exercises

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9.1: Introduction to Agency and the Types of Agents

Learning Objectives

By the end of this section, you will be able to:

- Understand why agency law is important.
- Recognize the recurring legal issues in agency law.
- Know the types of agents.
- Understand how the agency relationship is created.

Introduction to Agency Law

Why Is Agency Law Important, and What Is an Agent?

An agent is a person who acts in the name of and on behalf of another, having been given and assumed some degree of authority to do so. Most organized human activity—and virtually all commercial activity—is carried on through agency. No corporation would be possible, even in theory, without such a concept. We might say "General Motors is building cars in China," for example, but we can't shake hands with General Motors. "The General," as people say, exists and works through agents. Likewise, partnerships and other business organizations rely extensively on agents to conduct their business. Indeed, it is not an exaggeration to say that agency is the cornerstone of enterprise organization. In a partnership each partner is a general agent, while under corporation law the officers and all employees are agents of the corporation.

The existence of agents does not, however, require a whole new law of torts or contracts. A tort is no less harmful when committed by an agent; a contract is no less binding when negotiated by an agent. What does need to be taken into account, though, is the manner in which an agent acts on behalf of his principal and toward a third party.

Recurring Issues in Agency Law

Several problematic fact scenarios recur in agency, and law has developed in response.

John Alden

Consider John Alden (1599–1687), one of the most famous agents in American literature. He is said to have been the first person from the *Mayflower* to set foot on Plymouth Rock in 1620; he was a carpenter, a cooper (barrel maker), and a diplomat. His agency task—of interest here—was celebrated in Henry Wadsworth Longfellow's "The Courtship of Miles Standish." He was to woo Priscilla Mullins (d. 1680), "the loveliest maiden of Plymouth," on behalf of Captain Miles Standish, a valiant soldier who was too shy to propose marriage. Standish turned to John Alden, his young and eloquent protégé, and beseeched Alden to speak on his behalf, unaware that Alden himself was in love with Priscilla. Alden accepted his captain's assignment, despite the knowledge that he would thus lose Priscilla for himself, and sought out the lady. But Alden was so tongue-tied that his vaunted eloquence fell short, turned Priscilla cold toward the object of Alden's mission, and eventually led her to turn the tables in one of the most famous lines in American literature and poetry: "Why don't you speak for yourself, John?" John eventually did: the two were married in 1623 in Plymouth.

Recurring Issues in Agency

Let's analyze this sequence of events in legal terms—recognizing, of course, that this example is an analogy and that the law, even today, would not impose consequences on Alden for his failure to carry out Captain Standish's wishes. Alden was the captain's agent: he was specifically authorized to speak in his name in a manner agreed on, toward a specified end, and he accepted the assignment in consideration of the captain's friendship. He had, however, a conflict of interest. He attempted to carry out the assignment, but he did not perform according to expectations. Eventually, he wound up with the prize himself. Here are some questions to consider, the same questions that will recur throughout the discussion of agency:

- How extensive was John's authority? Could he have made promises to Priscilla on the captain's behalf—for example, that Standish would have built her a fine house?

- Could he, if he committed a tort, have imposed liability on his principal? Suppose, for example, that he had ridden at breakneck speed to reach Priscilla's side and while en route ran into and injured a pedestrian on the road. Could the pedestrian have sued Standish?
- Suppose Alden had injured himself on the journey. Would Standish be liable to Alden?
- Is Alden liable to Standish for stealing the heart of Priscilla—that is, for taking the "profits" of the enterprise for himself?

As these questions suggest, agency law often involves three parties—the principal, the agent, and a third party. It therefore deals with three different relationships: between principal and agent, between principal and third party, and between agent and third party. These relationships can be summed up in a simple diagram (see Figure 14.1).

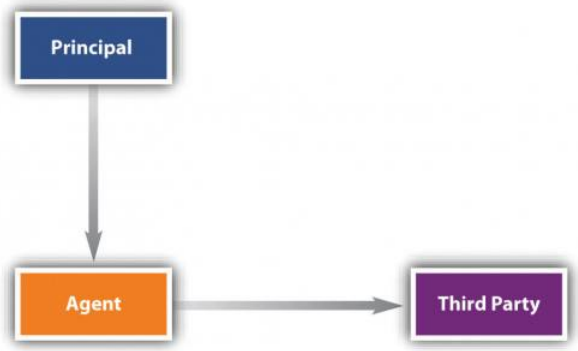


Figure 14.1 Agency Relationships

In this chapter, we will consider the principal-agent side of the triangle. In the next chapter we will turn to relationships involving third parties.

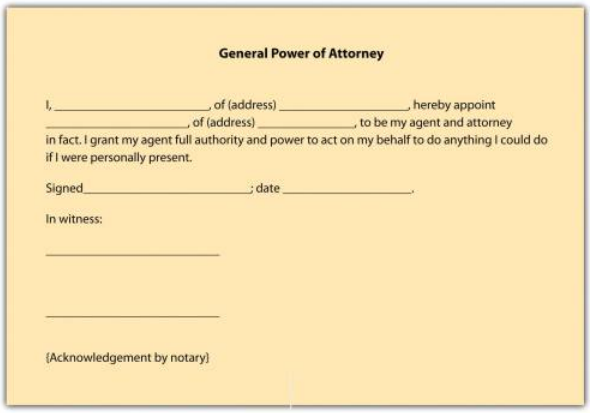
Types of Agents

There are five types of agents.

General Agent

The general agent possesses the authority to carry out a broad range of transactions in the name and on behalf of the principal. The general agent may be the manager of a business or may have a more limited but nevertheless ongoing role—for example, as a purchasing agent or as a life insurance agent authorized to sign up customers for the home office. In either case, the general agent has authority to alter the principal's legal relationships with third parties. One who is designated a general agent has the authority to act in any way required by the principal's business. To restrict the general agent's authority, the principal must spell out the limitations explicitly, and even so the principal may be liable for any of the agent's acts in excess of his authority.

Normally, the general agent is a business agent, but there are circumstances under which an individual may appoint a general agent for personal purposes. One common form of a personal general agent is the person who holds another's power of attorney. This is a delegation of authority to another to act in his stead; it can be accomplished by executing a simple form, such as the one shown in Figure 14.2. Ordinarily, the power of attorney is used for a special purpose—for example, to sell real estate or securities in the absence of the owner. But a person facing a lengthy operation and recuperation in a hospital might give a general power of attorney to a trusted family member or friend.



General Power of Attorney

I, _____, of (address) _____, hereby appoint _____, of (address) _____, to be my agent and attorney in fact. I grant my agent full authority and power to act on my behalf to do anything I could do if I were personally present.

Signed_____; date _____.

In witness:

_____

_____

(Acknowledgement by notary)

Figure 14.2 General Power of Attorney

Special Agent

The special agent is one who has authority to act only in a specifically designated instance or in a specifically designated set of transactions. For example, a real estate broker is usually a special agent hired to find a buyer for the principal's land. Suppose Sam, the seller, appoints an agent Alberta to find a buyer for his property. Alberta's commission depends on the selling price, which, Sam states in a letter to her, "in any event may be no less than $150,000." If Alberta locates a buyer, Bob, who agrees to purchase the property for $160,000, her signature on the contract of sale will not bind Sam. As a special agent, Alberta had authority only to find a buyer; she had no authority to sign the contract.

Agency Coupled with an Interest

An agent whose reimbursement depends on his continuing to have the authority to act as an agent is said to have an agency coupled with an interest if he has a property interest in the business. A literary or author's agent, for example, customarily agrees to sell a literary work to a publisher in return for a percentage of all monies the author earns from the sale of the work. The literary agent also acts as a collection agent to ensure that his commission will be paid. By agreeing with the principal that the agency is coupled with an interest, the agent can prevent his own rights in a particular literary work from being terminated to his detriment.

Subagent

To carry out her duties, an agent will often need to appoint her own agents. These appointments may or may not be authorized by the principal. An insurance company, for example, might name a general agent to open offices in cities throughout a certain state. The agent will necessarily conduct her business through agents of her own choosing. These agents are subagents of the principal if the general agent had the express or implied authority of the principal to hire them. For legal purposes, they are agents of both the principal and the principal's general agent, and both are liable for the subagent's conduct although normally the general agent agrees to be primarily liable (see Figure 14.3).

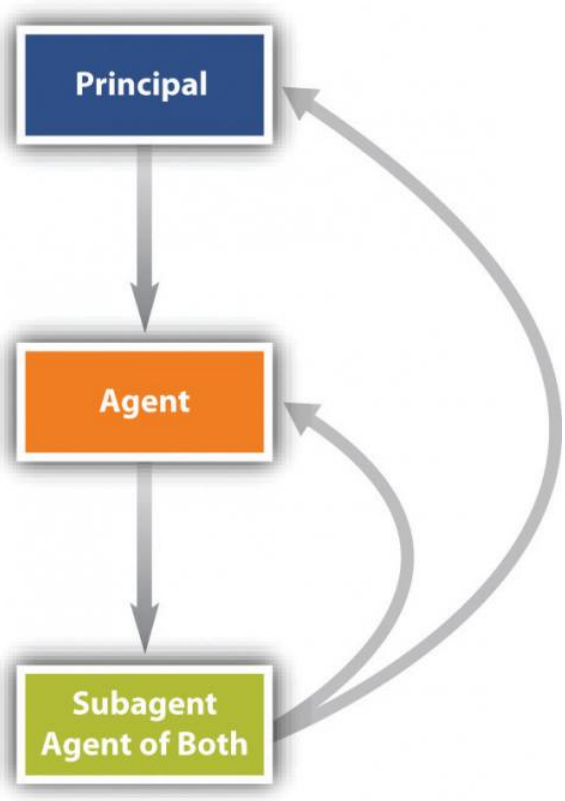


Figure 14.3 Subagent

Servant

The final category of agent is the servant. Until the early nineteenth century, any employee whose work duties were subject to an employer's control was called a servant; we would not use that term so broadly in modern English. The Restatement (Second) of Agency, Section 2, defines a servant as "an agent employed by a master [employer] to perform service in his affairs whose physical conduct in the performance of the service is controlled or is subject to the right to control by the master."

Independent Contractor

Not every contract for services necessarily creates a master-servant relationship. There is an important distinction made between the status of a servant and that of an independent contractor. According to the Restatement (Second) of Agency, Section 2, As the name implies, the independent contractor is legally autonomous. A plumber salaried to a building contractor is an employee and agent of the contractor. But a plumber who hires himself out to repair pipes in people's homes is an independent contractor. If you hire a lawyer to settle a dispute, that person is not your employee or your servant; she is an independent contractor. The terms "agent" and "independent contractor" are not necessarily mutually exclusive. In fact, by definition, "… an independent contractor is an agent in the broad sense of the term in undertaking, at the request of another, to do something for the other. As a general rule the line of demarcation between an independent contractor and a servant is not clearly drawn."1. *Flick v. Crouch*, 434 P.2d 256, 260 (OK, 1967).

This distinction between agent and independent contractor has important legal consequences for taxation, workers' compensation, and liability insurance. For example, employers are required to withhold income taxes from their employees' paychecks. But payment to an independent contractor, such as the plumber for hire, does not require such withholding. Deciding who is an independent contractor is not always easy; there is no single factor or mechanical answer. In *Robinson v. New York Commodities Corp.*, an injured salesman sought workers' compensation benefits, claiming to be an employee of the New York Commodities Corporation.*Robinson v. New York Commodities Corp.*, 396 N.Y.S.2d 725, App. Div. (1977). But the state workmen's compensation board ruled against him, citing a variety of factors. The claimant sold canned meats, making rounds in his car from his home. The company did not establish hours for him, did not control his movements in any way, and did not reimburse him for

mileage or any other expenses or withhold taxes from its straight commission payments to him. He reported his taxes on a form for the self-employed and hired an accountant to prepare it for him. The court agreed with the compensation board that these facts established the salesman's status as an independent contractor.

The factual situation in each case determines whether a worker is an employee or an independent contractor. Neither the company nor the worker can establish the worker's status by agreement. As the North Dakota Workmen's Compensation Bureau put it in a bulletin to real estate brokers, "It has come to the Bureau's attention that many employers are requiring that those who work for them sign 'independent contractor' forms so that the employer does not have to pay workmen's compensation premiums for his employees. Such forms are meaningless if the worker is in fact an employee." *Vizcaino v. Microsoft Corporation*, discussed in Section 14.3.2 "Employee versus Independent Contractor", examines the distinction.

In addition to determining a worker's status for tax and compensation insurance purposes, it is sometimes critical for decisions involving personal liability insurance policies, which usually exclude from coverage accidents involving employees of the insureds. *General Accident Fire & Life Assurance Corp v. Pro Golf AssociationGeneral Accident Fire & Life Assurance Corp v. Pro Golf Association*, 352 N.E.2d 441 (Ill. App. 1976). involved such a situation. The insurance policy in question covered members of the Professional Golfers Association. Gerald Hall, a golf pro employed by the local park department, was afforded coverage under the policy, which excluded "bodily injury to any employee of the insured arising out of and in the course of his employment by the insured." That is, no employee of Hall's would be covered (rather, any such person would have coverage under workers' compensation statutes). Bradley Martin, age thirteen, was at the golf course for junior league play. At Hall's request, he agreed to retrieve or "shag" golf balls to be hit during a lesson Hall was giving; he was—as Hall put it—to be compensated "either through golf instructions or money or hotdogs or whatever." During the course of the lesson, a golf ball hit by Hall hit young Martin in the eye. If Martin was an employee, the insurance company would be liable; if he was not an employee, the insurance company would not liable. The trial court determined he was not an employee. The evidence showed: sometimes the boys who "shagged" balls got paid, got golfing instructions, or got food, so the question of compensation was ambiguous. Martin was not directed in how to perform (the admittedly simple) task of retrieving golf balls, no control was exercised over him, and no equipment was required other than a bag to collect the balls: "We believe the evidence is susceptible of different inferences.…We cannot say that the decision of the trial court is against the manifest weight of the evidence."

Creation of the Agency Relationship

The agency relationship can be created in two ways: by agreement (expressly) or by operation of law (constructively or impliedly).

Agency Created by Agreement

Most agencies are created by contract. Thus the general rules of contract law covered in Chapter 8 govern the law of agency. But agencies can also be created without contract, by agreement. Therefore, three contract principles are especially important: the first is the requirement for consideration, the second for a writing, and the third concerns contractual capacity.

Consideration

Agencies created by consent—agreement—are not necessarily contractual. It is not uncommon for one person to act as an agent for another without consideration. For example, Abe asks Byron to run some errands for him: to buy some lumber on his account at the local lumberyard. Such a gratuitous agency gives rise to no different results than the more common contractual agency.

Formalities

Most oral agency contracts are legally binding; the law does not require that they be reduced to writing. In practice, many agency contracts are written to avoid problems of proof. And there are situations where an agency contract must be in writing: (1) if the agreed-on purpose of the agency cannot be fulfilled within one year or if the agency relationship is to last more than one year; (2) in many states, an agreement to pay a commission to a real estate broker; (3) in many states, authority given to an agent to sell real estate; and (4) in several states, contracts between companies and sales representatives.

Even when the agency contract is not required to be in writing, contracts that agents make with third parties often must be in writing. Thus Section 2-201 of the Uniform Commercial Code specifically requires contracts for the sale of goods for the price of five hundred dollars or more to be in writing and "signed by the party against whom enforcement is sought or by his authorized agent."

Capacity

A contract is void or voidable when one of the parties lacks capacity to make one. If both principal and agent lack capacity—for example, a minor appoints another minor to negotiate or sign an agreement—there can be no question of the contract's voidability. But suppose only one or the other lacks capacity. Generally, the law focuses on the principal. If the principal is a minor or otherwise lacks capacity, the contract can be avoided even if the agent is fully competent. There are, however, a few situations in which the capacity of the agent is important. Thus a mentally incompetent agent cannot bind a principal.

Agency Created by Operation of Law

Most agencies are made by contract, but agency also may arise impliedly or apparently.

Implied Agency

In areas of social need, courts have declared an agency to exist in the absence of an agreement. The agency relationship then is said to have been implied "by operation of law." Children in most states may purchase necessary items—food or medical services—on the parent's account. Long-standing social policy deems it desirable for the head of a family to support his dependents, and the courts will put the expense on the family head in order to provide for the dependents' welfare. The courts achieve this result by supposing the dependent to be the family head's agent, thus allowing creditors to sue the family head for the debt.

Implied agencies also arise where one person behaves as an agent would and the "principal," knowing that the "agent" is behaving so, acquiesces, allowing the person to hold himself out as an agent. Such are the basic facts in *Weingart v. Directoire Restaurant, Inc.* in Section 14.3.1 "Creation of Agency: Liability of Parent for Contracts Made by "Agent" Child".

Apparent Agency

Suppose Arthur is Paul's agent, employed through October 31. On November 1, Arthur buys materials at Lumber Yard—as he has been doing since early spring—and charges them to Paul's account. Lumber Yard, not knowing that Arthur's employment terminated the day before, bills Paul. Will Paul have to pay? Yes, because the termination of the agency was not communicated to Lumber Yard. It *appeared* that Arthur was an authorized agent. This issue is discussed further in Chapter 15.

Key Takeaway

An agent is one who acts on behalf of another. Many transactions are conducted by agents so acting. All corporate transactions, including those involving governmental organizations, are so conducted because corporations cannot themselves actually act; they are legal fictions. Agencies may be created expressly, impliedly, or apparently. Recurring issues in agency law include whether the "agent" really is such, the scope of the agent's authority, and the duties among the parties. The five types of agents include: general agent, special agent, subagent, agency coupled with an interest, and servant (or employee). The independent contractor is not an employee; her activities are not specifically controlled by her client, and the client is not liable for payroll taxes, Social Security, and the like. But it is not uncommon for an employer to claim workers are independent contractors when in fact they are employees, and the cases are often hard-fought on the facts.

Exercises

1. Why is agency law especially important in the business and government context?
2. What are the five types of agents?
3. What distinguishes an employee from an independent contractor?
4. Why do employers frequently try to pass off employees as independent contractors?

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9.2: Duties between Agent and Principal

Learning Objectives

By the end of this section, you will be able to:

- Understand that the agent owes the principal two types of duties: a special duty—the fiduciary duty—and other general duties as recognized in agency law.
- Recognize that the principal owes the agent duties: contract, tort, and workers' compensation.

Agent's Duty to Principal

The agent owes the principal duties in two categories: the fiduciary duty and a set of general duties imposed by agency law. But these general duties are not unique to agency law; they are duties owed by any employee to the employer.

Fiduciary Duty

In a nonagency contractual situation, the parties' responsibilities terminate at the border of the contract. There is no relationship beyond the agreement. This literalist approach is justified by the more general principle that we each should be free to act unless we commit ourselves to a particular course.

But the agency relationship is more than a contractual one, and the agent's responsibilities go beyond the border of the contract. Agency imposes a higher duty than simply to abide by the contract terms. It imposes a fiduciary duty. The law infiltrates the contract creating the agency relationship and reverses the general principle that the parties are free to act in the absence of agreement. As a fiduciary of the principal, the agent stands in a position of special trust. His responsibility is to subordinate his self-interest to that of his principal. The fiduciary responsibility is imposed by law. The absence of any clause in the contract detailing the agent's fiduciary duty does not relieve him of it. The duty contains several aspects.

Duty to Avoid Self-Dealing

A fiduciary may not lawfully profit from a conflict between his personal interest in a transaction and his principal's interest in that same transaction. A broker hired as a purchasing agent, for instance, may not sell to his principal through a company in which he or his family has a financial interest. The penalty for breach of fiduciary duty is loss of compensation and profit and possible damages for breach of trust.

Duty to Preserve Confidential Information

To further his objectives, a principal will usually need to reveal a number of secrets to his agent—how much he is willing to sell or pay for property, marketing strategies, and the like. Such information could easily be turned to the disadvantage of the principal if the agent were to compete with the principal or were to sell the information to those who do. The law therefore prohibits an agent from using for his own purposes or in ways that would injure the interests of the principal, information confidentially given or acquired. This prohibition extends to information gleaned from the principal though unrelated to the agent's assignment: "[A]n agent who is told by the principal of his plans, or who secretly examines books or memoranda of the employer, is not privileged to use such information at his principal's expense."Restatement (Second) of Agency, Section 395. Nor may the agent use confidential information after resigning his agency. Though he is free, in the absence of contract, to compete with his former principal, he may not use information learned in the course of his agency, such as trade secrets and customer lists. Section 14.3.3 "Breach of Fiduciary Duty", *Bacon v. Volvo Service Center, Inc.*, deals with an agent's breach of the duty of confidentiality.

Other Duties

In addition to fiduciary responsibility (and whatever special duties may be contained in the specific contract) the law of agency imposes other duties on an agent. These duties are not necessarily unique to agents: a nonfiduciary employee could also be bound to these duties on the right facts.

Duty of Skill and Care

An agent is usually taken on because he has special knowledge or skills that the principal wishes to tap. The agent is under a legal duty to perform his work with the care and skill that is "standard in the locality for the kind of work which he is employed to perform" and to exercise any special skills, if these are greater or more refined than those prevalent among those normally employed in the community. In short, the agent may not lawfully do a sloppy job.Restatement (Second) of Agency, Section 379.

Duty of Good Conduct

In the absence of an agreement, a principal may not ordinarily dictate how an agent must live his private life. An overly fastidious florist may not instruct her truck driver to steer clear of the local bar on his way home from delivering flowers at the end of the day. But there are some jobs on which the personal habits of the agent may have an effect. The agent is not at liberty to act with impropriety or notoriety, so as to bring disrepute on the business in which the principal is engaged. A lecturer at an antialcohol clinic may be directed to refrain from frequenting bars. A bank cashier who becomes known as a gambler may be fired.

Duty to Keep and Render Accounts

The agent must keep accurate financial records, take receipts, and otherwise act in conformity to standard business practices.

Duty to Act Only as Authorized

This duty states a truism but is one for which there are limits. A principal's wishes may have been stated ambiguously or may be broad enough to confer discretion on the agent. As long as the agent acts reasonably under the circumstances, he will not be liable for damages later if the principal ultimately repudiates what the agent has done: "Only conduct which is contrary to the principal's manifestations to him, interpreted in light of what he has reason to know at the time when he acts,…subjects the agent to liability to the principal."Restatement (Second) of Agency, Section 383.

Duty Not to Attempt the Impossible or Impracticable

The principal says to the agent, "Keep working until the job is done." The agent is not obligated to go without food or sleep because the principal misapprehended how long it would take to complete the job. Nor should the agent continue to expend the principal's funds in a quixotic attempt to gain business, sign up customers, or produce inventory when it is reasonably clear that such efforts would be in vain.

Duty to Obey

As a general rule, the agent must obey reasonable directions concerning the manner of performance. What is reasonable depends on the customs of the industry or trade, prior dealings between agent and principal, and the nature of the agreement creating the agency. A principal may prescribe uniforms for various classes of employees, for instance, and a manufacturing company may tell its sales force what sales pitch to use on customers. On the other hand, certain tasks entrusted to agents are not subject to the principal's control; for example, a lawyer may refuse to permit a client to dictate courtroom tactics.

Duty to Give Information

Because the principal cannot be every place at once—that is why agents are hired, after all—much that is vital to the principal's business first comes to the attention of agents. If the agent has actual notice or reason to know of information that is relevant to matters entrusted to him, he has a duty to inform the principal. This duty is especially critical because information in the hands of an agent is, under most circumstances, imputed to the principal, whose legal liabilities to third persons may hinge on receiving information in timely fashion. Service of process, for example, requires a defendant to answer within a certain number of days; an agent's failure to communicate to the principal that a summons has been served may bar the principal's right to defend a lawsuit. The imputation to the principal of knowledge possessed by the agent is strict: even where the agent is acting adversely to the principal's interests—for example, by trying to defraud his employer—a third party may still rely on notification to the agent, unless the third party knows the agent is acting adversely.

“Shop Rights” Doctrine

In *Grip Nut Co. v. Sharp*, Sharp made a deal with Grip Nut Company that in return for a salary and bonuses as company president, he would assign to the company any inventions he made.*Grip Nut Co. v. Sharp*, 150 F.2d 192 (7th Cir. 1945). When the five-year employment contract expired, Sharp continued to serve as chief executive officer, but no new contract was negotiated concerning either pay or rights to inventions. During the next ten years, Sharp invented a number of new products and developed new machinery to manufacture them; patent rights went to the company. However, he made one invention with two other employees and they assigned the patent to him. A third employee invented a safety device and also assigned the patent to Sharp. At one time, Sharp’s son invented a leakproof bolt and a process to manufacture it; these, too, were assigned to Sharp. These inventions were developed in the company’s plants at its expense.

When Sharp died, his family claimed the rights to the inventions on which Sharp held assignments and sued the company, which used the inventions, for patent infringement. The family reasoned that after the expiration of the employment contract, Sharp was employed only in a managerial capacity, not as an inventor. The court disagreed and invoked the shop rights doctrine, under which an invention “developed and perfected in [a company’s] plant with its time, materials, and appliances, and wholly at its expense” may be used by the company without payment of royalties: “Because the servant uses his master’s time, facilities and materials to attain a concrete result, the employer is entitled to use that which embodies his own property and to duplicate it as often as he may find occasion to employ similar appliances in his business.” The company would have been given complete ownership of the patents had there been an express or implied (e.g., the employee is hired to make inventions) contract to this effect between Sharp and the company.

Principal’s Duty to Agent

In this category, we may note that the principal owes the agent duties in contract, tort, and—statutorily—workers’ compensation law.

Contract Duties

The fiduciary relationship of agent to principal does not run in reverse—that is, the principal is not the agent’s fiduciary. Nevertheless, the principal has a number of contractually related obligations toward his agent.

General Contract Duties

These duties are analogues of many of the agent’s duties that we have just examined. In brief, a principal has a duty “to refrain from unreasonably interfering with [an agent’s] work.”Restatement (Second) of Agency, Section 434. The principal is allowed, however, to compete with the agent unless the agreement specifically prohibits it. The principal has a duty to inform his agent of risks of physical harm or pecuniary loss that inhere in the agent’s performance of assigned tasks. Failure to warn an agent that travel in a particular neighborhood required by the job may be dangerous (a fact unknown to the agent but known to the principal) could under common law subject the principal to a suit for damages if the agent is injured while in the neighborhood performing her job. A principal is obliged to render accounts of monies due to agents; a principal’s obligation to do so depends on a variety of factors, including the degree of independence of the agent, the method of compensation, and the customs of the particular business. An agent’s reputation is no less valuable than a principal’s, and so an agent is under no obligation to continue working for one who sullies it.

Employment at Will

Under the traditional “employment-at-will” doctrine, an employee who is not hired for a specific period can be fired at any time, for any reason (except bad reasons: an employee cannot be fired, for example, for reporting that his employer’s paper mill is illegally polluting groundwater). This doctrine, which has been much criticized, is discussed in Chapter 33.

Duty to Indemnify

Agents commonly spend money pursuing the principal’s business. Unless the agreement explicitly provides otherwise, the principal has a duty to indemnify or reimburse the agent. A familiar form of indemnity is the employee expense account.

Tort and Workers' Compensation Duties

The employer owes the employee—any employee, not just agents—certain statutorily imposed tort and workers' compensation duties.

Background to Workers' Compensation

Andy, who works in a dynamite factory, negligently stores dynamite in the wrong shed. Andy warns his fellow employee Bill that he has done so. Bill lights up a cigarette near the shed anyway, a spark lands on the ground, the dynamite explodes, and Bill is injured. May Bill sue his employer to recover damages? At common law, the answer would be no—three times no. First, the "fellow-servant" rule would bar recovery because the employer was held not to be responsible for torts committed by one employee against another. Second, Bill's failure to heed Andy's warning and his decision to smoke near the dynamite amounted to contributory negligence. Hence even if the dynamite had been negligently stored by the employer rather than by a fellow employee, the claim would have been dismissed. Third, the courts might have held that Bill had "assumed the risk": since he was aware of the dangers, it would not be fair to saddle the employer with the burden of Bill's actions.

The three common-law rules just mentioned ignited intense public fury by the turn of the twentieth century. In large numbers of cases, workers who were mutilated or killed on the job found themselves and their families without recompense. Union pressure and grass roots lobbying led to workers' compensation acts—statutory enactments that dramatically overhauled the law of torts as it affected employees.

The System in General

Workers' compensation is a no-fault system. The employee gives up the right to sue the employer (and, in some states, other employees) and receives in exchange predetermined compensation for a job-related injury, regardless of who caused it. This trade-off was felt to be equitable to employer and employee: the employee loses the right to seek damages for pain and suffering—which can be a sizable portion of any jury award—but in return he can avoid the time-consuming and uncertain judicial process and assure himself that his medical costs and a portion of his salary will be paid—and paid promptly. The employer must pay for all injuries, even those for which he is blameless, but in return he avoids the risk of losing a big lawsuit, can calculate his costs actuarially, and can spread the risks through insurance.

Most workers' compensation acts provide 100 percent of the cost of a worker's hospitalization and medical care necessary to cure the injury and relieve him from its effects. They also provide for payment of lost wages and death benefits. Even an employee who is able to work may be eligible to receive compensation for specific injuries. Part of the table of benefits for specific injuries under the Kansas statute is shown in Note 14.16 "Kansas Workers' Compensation Benefits for Specific Injuries".

Kansas Workers' Compensation Benefits for Specific Injuries

Article 5.—Workers' Compensation

44-510d. Compensation for certain permanent partial disabilities; schedule. If there is an award of permanent disability as a result of the injury there shall be a presumption that disability existed immediately after the injury and compensation is to be paid for not to exceed the number of weeks allowed in the following schedule:

(1) For loss of a thumb, 60 weeks.

(2) For the loss of a first finger, commonly called the index finger, 37 weeks.

(3) For the loss of a second finger, 30 weeks.

(4) For the loss of a third finger, 20 weeks.

(5) For the loss of a fourth finger, commonly called the little finger, 15 weeks.

(6) Loss of the first phalange of the thumb or of any finger shall be considered to be equal to the loss of 1/2 of such thumb or finger, and the compensation shall be 1/2 of the amount specified above. The loss of the first phalange and any part of the second phalange of any finger, which includes the loss of any part of the bone of such second phalange, shall be considered to be equal to the loss of 2/3 of such finger and the compensation shall be 2/3 of the amount specified above. The loss of the first phalange and any part of the second phalange of a thumb which includes the loss of any part of the bone of such second phalange, shall be

considered to be equal to the loss of the entire thumb. The loss of the first and second phalanges and any part of the third proximal phalange of any finger, shall be considered as the loss of the entire finger. Amputation through the joint shall be considered a loss to the next higher schedule.

(7) For the loss of a great toe, 30 weeks.

(8) For the loss of any toe other than the great toe, 10 weeks.

(9) The loss of the first phalange of any toe shall be considered to be equal to the loss of 1/2 of such toe and the compensation shall be 1/2 of the amount above specified.

(10) The loss of more than one phalange of a toe shall be considered to be equal to the loss of the entire toe.

(11) For the loss of a hand, 150 weeks.

(12) For the loss of a forearm, 200 weeks.

(13) For the loss of an arm, excluding the shoulder joint, shoulder girdle, shoulder musculature or any other shoulder structures, 210 weeks, and for the loss of an arm, including the shoulder joint, shoulder girdle, shoulder musculature or any other shoulder structures, 225 weeks.

(14) For the loss of a foot, 125 weeks.

(15) For the loss of a lower leg, 190 weeks.

(16) For the loss of a leg, 200 weeks.

(17) For the loss of an eye, or the complete loss of the sight thereof, 120 weeks.

Source:
www.kslegislature.org/li/statute/044_000_0000_chapter/044_005_0000_article/044_005_0010d_section/044_005_0010d_k/.

The injured worker is typically entitled to two-thirds his or her average pay, not to exceed some specified maximum, for two hundred weeks. If the loss is partial (like partial loss of sight), the recovery is decreased by the percentage still usable.

Coverage

Although workers' compensation laws are on the books of every state, in two states—New Jersey and Texas—they are not compulsory. In those states the employer may decline to participate, in which event the employee must seek redress in court. But in those states permitting an employer election, the old common-law defenses (fellow-servant rule, contributory negligence, and assumption of risk) have been statutorily eliminated, greatly enhancing an employee's chances of winning a suit. The incentive is therefore strong for employers to elect workers' compensation coverage.

Those frequently excluded are farm and domestic laborers and public employees; public employees, federal workers, and railroad and shipboard workers are covered under different but similar laws. The trend has been to include more and more classes of workers. Approximately half the states now provide coverage for household workers, although the threshold of coverage varies widely from state to state. Some use an earnings test; other states impose an hours threshold. People who fall within the domestic category include maids, baby-sitters, gardeners, and handymen but generally not plumbers, electricians, and other independent contractors.

Paying for Workers' Compensation

There are three general methods by which employers may comply with workers' compensation laws. First, they may purchase employer's liability and workers' compensation policies through private commercial insurance companies. These policies consist of two major provisions: payment by the insurer of all claims filed under workers' compensation and related laws (such as occupational disease benefits) and coverage of the costs of defending any suits filed against the employer, including any judgments awarded. Since workers' compensation statutes cut off the employee's right to sue, how can such a lawsuit be filed? The answer is that there are certain exceptions to the ban: for instance, a worker may sue if the employer deliberately injures an employee.

The second method of compliance with workers' compensation laws is to insure through a state fund established for the purpose. The third method is to self-insure. The laws specify conditions under which companies may resort to self-insurance, and generally

only the largest corporations qualify to do so. In short, workers' compensation systems create a tax on employers with which they are required (again, in most states) to buy insurance. The amount the employer has to pay for the insurance depends on the number and seriousness of claims made—how dangerous the work is. For example, Washington State's 2011 proposed hourly rates for employers to purchase insurance include these items: for egg and poultry farms, $1.16 per hour; shake and shingle mills, $18.06 per hour; asphalt paving, $2.87 per hour; lawn care maintenance, $1.22 per hour; plastic products manufacturing, $0.87 per hour; freight handling, $1.81 per hour; supermarkets, $0.76; restaurants, $0.43; entertainers and dancers, $7.06; colleges and universities, $0.31.Washington State Department of Labor & Industries, *Rates for Workers' Compensation, Proposed 2011 Rates*, www.lni.wa.gov/ClaimsIns/Insurance/RatesRisk/Check/RatesHistory.

Recurring Legal Issues

There are a number of legal issues that recur in workers' compensation cases. The problem is, from the employer's point of view, that the cost of buying insurance is tied to the number of claims made. The employer therefore has reason to assert the injured employee is not eligible for compensation. Recurring legal issues include the following:

- Is the injury work related? As a general rule, on-the-job injuries are covered no matter what their relationship to the employee's specific duties. Although injuries resulting from drunkenness or fighting are not generally covered, there are circumstances under which they will be, as Section 14.3.2 "Employee versus Independent Contractor" shows.
- Is the injured person an employee? Courts are apt to be liberal in construing statutes to include those who might not seem to be employed. In *Betts v. Ann Arbor Public Schools*, a University of Michigan student majoring in physical education was a student teacher in a junior high school.*Betts v. Ann Arbor Public Schools*, 271 N.W.2d 498 (Mich. 1978). During a four-month period, he taught two physical education courses. On the last day of his student teaching, he walked into the locker room and thirty of his students grabbed him and tossed him into the swimming pool. This was traditional, but he "didn't feel like going in that morning" and put up a struggle that ended with a whistle on an elastic band hitting him in the eye, which he subsequently lost as a result of the injury. He filed a workers' compensation claim. The school board argued that he could not be classified as an employee because he received no pay. Since he was injured by students—not considered agents of the school—he would probably have been unsuccessful in filing a tort suit; hence the workers' compensation claim was his only chance of recompense. The state workers' compensation appeal board ruled against the school on the ground that payment in money was not required: "Plaintiff was paid in the form of training, college credits towards graduation, and meeting of the prerequisites of a state provisional certificate." The state supreme court affirmed the award.
- How palpable must the "injury" be? A difficult issue is whether a worker is entitled to compensation for psychological injury, including cumulative trauma. Until the 1970s, insurance companies and compensation boards required physical injury before making an award. Claims that job stresses led to nervous breakdowns or other mental disorders were rejected. But most courts have liberalized the definition of injury and now recognize that psychological trauma can be real and that job stress can bring it on, as shown by the discussion of *Wolfe v. Sibley, Lindsay & Curr Co.* in Section 14.3.4 "Workers' Compensation: What "Injuries" Are Compensable?".

Key Takeaway

The agent owes the principal two categories of duties: fiduciary and general. The fiduciary duty is the duty to act always in the interest of the principal; the duty here includes that to avoid self-dealing and to preserve confidential information. The general duty owed by the agent encompasses the sorts of obligations any employee might have: the duty of skill and care, of good conduct, to keep and render accounts, to not attempt the impossible or impracticable, to obey, and to give information. The shop rights doctrine provides that inventions made by an employee using the employer's resources and on the employer's time belong to the employer.

The principal owes the agent duties too. These may be categorized as contract and tort duties. The contract duties are to warn the agent of hazards associated with the job, to avoid interfering with the agent's performance of his job, to render accounts of money due the agent, and to indemnify the agent for business expenses according to their agreement. The tort duty owed by the principal to the agent—employee—is primarily the statutorily imposed duty to provide workers' compensation for injuries sustained on the job. In reaction to common-law defenses that often exonerated the employer from liability for workers' injuries, the early twentieth century saw the rise of workers' compensation statutes. These require the employer to provide no-fault insurance coverage for any injury sustained by the employee on the job. Because the employer's insurance costs are claims rated (i.e., the cost of insurance

depends on how many claims are made), the employer scrutinizes claims. A number of recurring legal issues arise: Is the injury work related? Is the injured person an employee? What constitutes an “injury”?

Exercises

1. Judge Learned Hand, a famous early-twentieth-century jurist (1872–1961), said, “The fiduciary duty is not the ordinary morals of the marketplace.” How does the fiduciary duty differ from “the ordinary morals of the marketplace”? Why does the law impose a fiduciary duty on the agent?
2. What are the nonfiduciary duties owed by the agent to the principal?
3. What contract duties are owed by the principal to the agent?
4. Why were workers’ compensation statutes adopted in the early twentieth century?
5. How do workers’ compensation statutes operate, and how are the costs paid for?

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9.3: Cases

Creation of Agency: Liability of Parent for Contracts Made by “Agent” Child

Weingart v. Directoire Restaurant, Inc.

333 N.Y.S.2d 806 (N.Y., 1972)

KASSEL, J.

The issue here is whether defendant restaurant by permitting an individual to park patrons’ cars thereby held him out as its “employee” for such purposes. Admittedly, this individual, one Buster Douglas, is not its employee in the usual sense but with the knowledge of defendant, he did station himself in front of its restaurant, wore a doorman’s uniform and had been parking its customers’ autos. The parties stipulated that if he were held to be defendant’s employee, this created a bailment between the parties [and the “employer” would have to rebut a presumption of negligence if the customer’s property was not returned to the customer].

On April 20, 1968, at about 10 P.M., plaintiff drove his 1967 Cadillac Coupe de Ville to the door of the Directoire Restaurant at 160 East 48th Street in Manhattan. Standing in front of the door was Buster Douglas, dressed in a self-supplied uniform, comprised of a regular doorman’s cap and matching jacket. Plaintiff gave the keys to his vehicle to Douglas and requested that he park the car. He gave Douglas a $1.00 tip and received a claim check. Plaintiff then entered defendant’s restaurant, remained there for approximately 45 minutes and when he departed, Douglas was unable to locate the car which was never returned to plaintiff.

At the time of this occurrence, the restaurant had been open for only nine days, during which time plaintiff had patronized the restaurant on at least one prior occasion.

Defendant did not maintain any sign at its entrance or elsewhere that it would provide parking for its customers (nor, apparently, any sign warning to the contrary).

Buster Douglas parked cars for customers of defendant’s restaurant and at least three or four other restaurants on the block. He stationed himself in front of each restaurant during the course of an evening and was so engaged during the evening of April 20, 1968. Defendant clearly knew of and did not object to Douglas’ activities outside its restaurant. Defendant’s witness testified at an examination before trial:

Q. Did anybody stand outside your restaurant in any capacity whatsoever?

A. There was a man out there parking cars for the block, but he was in no way connected with us or anything like that. He parked cars for the Tamburlaine and also for the Chateau Madrid, Nepentha and a few places around the block.

Q. Did you know that this gentleman was standing outside your restaurant?

A. Yes, I knew he was there.

Q. How did you know that he was standing outside your restaurant?

A. Well, I knew the man’s face because I used to work in a club on 55th Street and he was there. When we first opened up here, we didn’t know if we would have a doorman or have parking facilities or what we were going to do at that time. We just let it hang and I told this Buster, Buster was his name, that you are a free agent and you do whatever you want to do. I am tending bar in the place and what you do in the street is up to you, I will not stop you, but we are not hiring you or anything like that, because at that time, we didn’t know what we were going to use the parking lot or get a doorman and put on a uniform or what.

These facts establish to the court’s satisfaction that, although Douglas was not an actual employee of the restaurant, defendant held him out as its authorized agent or “employee” for the purpose of parking its customers’ cars, by expressly consenting to his standing, in uniform, in front of its door to receive customers, to park their cars and issue receipts therefor—which services were rendered without charge to the restaurant’s customers, except for any gratuity paid to Douglas. Clearly, under these circumstances, apparent authority has been shown and Douglas acted within the scope of this authority.

Plaintiff was justified in assuming that Douglas represented the restaurant in providing his services and that the restaurant had placed him there for the convenience of its customers. A restaurateur knows that this is the impression created by allowing a uniformed attendant to so act. Facility in parking is often a critical consideration for a motorist in selecting a restaurant in midtown

Manhattan, and the Directoire was keenly aware of this fact as evidenced by its testimony that the management was looking into various other possibilities for solving customers' parking problems.

There was no suitable disclaimer posted outside the restaurant that it had no parking facilities or that entrusting one's car to any person was at the driver's risk. It is doubtful that any prudent driver would entrust his car to a strange person on the street, if he thought that the individual had no authorization from the restaurant or club or had no connection with it, but was merely an independent operator with questionable financial responsibility.

The fact that Douglas received no compensation directly from defendant is not material. Each party derived a benefit from the arrangement: Douglas being willing to work for gratuities from customers, and the defendant, at no cost to itself, presenting the appearance of providing the convenience of free parking and doorman services to its patrons. In any case, whatever private arrangements existed between the restaurant and Douglas were never disclosed to the customers.

Even if such person did perform these services for several restaurants, it does not automatically follow that he is a freelance entrepreneur, since a shared employee working for other small or moderately sized restaurants in the area would seem a reasonable arrangement, in no way negating the authority of the attendant to act as doorman and receive cars for any one of these places individually.

The case most analogous to the instant one is *Klotz v. El Morocco* [Citation, 1968], and plaintiff here relies on it. That case similarly involved the theft of a car parked by a uniformed individual standing in front of defendant's restaurant who, although not employed by it, parked vehicles for its patrons with the restaurant's knowledge and consent. Defendant here attempts to distinguish this case principally upon the ground that the parties in El Morocco *stipulated* that the 'doorman' was an agent or employee of the defendant acting within the scope of his authority. However, the judge made an express finding to that effect: '* * * there was sufficient evidence in plaintiff's case on which to find DiGiovanni, the man in the uniform, was acting within the scope of his authority as agent of defendant." Defendant here also points to the fact that in *Klotz* DiGiovanni placed patrons' car keys on a rack inside El Morocco; however, this is only one fact to be considered in finding a bailment and is, to me, more relevant to the issue of the degree of care exercised.

When defendant's agent failed to produce plaintiff's automobile, a presumption of negligence arose which now requires defendant to come forward with a sufficient explanation to rebut this presumption. [Citation] The matter should be set down for trial on the issues of due care and of damages.

? Case Questions

1. Buster Douglas was not the restaurant's employee. Why did the court determine his negligence could nevertheless be imputed to the restaurant?
2. The plaintiff in this case relied on *Klotz*, very similar in facts, in which the car-parking attendant *was* found to be an employee. The defendant, necessarily, needed to argue that the cases were not very similar. What argument did the defendant make? What did the court say about that argument?
3. The restaurant here is a bailee—it has rightful possession of the plaintiff's (bailor's) property, the car. If the car is not returned to the plaintiff a rebuttable presumption of negligence arises. What does that mean?

Employee versus Independent Contractor

Vizcaino v. Microsoft Corp.

97 F.3d 1187 (9th Cir. 1996)

Reinhardt, J.

Large corporations have increasingly adopted the practice of hiring temporary employees or independent contractors as a means of avoiding payment of employee benefits, and thereby increasing their profits. This practice has understandably led to a number of problems, legal and otherwise. One of the legal issues that sometimes arises is exemplified by this lawsuit. The named plaintiffs, who were classified by Microsoft as independent contractors, seek to strip that label of its protective covering and to obtain for themselves certain benefits that the company provided to all of its regular or permanent employees. After certifying the named plaintiffs as representatives of a class of "common-law employees," the district court granted summary judgment to Microsoft on

all counts. The plaintiffs…now appeal as to two of their claims: a) the claim…that they are entitled to savings benefits under Microsoft's Savings Plus Plan (SPP); and b) that…they are entitled to stock-option benefits under Microsoft's Employee Stock Purchase Plan (ESPP). In both cases, the claims are based on their contention that they are common-law employees.

Microsoft, one of the country's fastest growing and most successful corporations and the world's largest software company, produces and sells computer software internationally. It employs a core staff of permanent employees. It categorizes them as "regular employees" and offers them a wide variety of benefits, including paid vacations, sick leave, holidays, short-term disability, group health and life insurance, and pensions, as well as the two benefits involved in this appeal. Microsoft supplements its core staff of employees with a pool of individuals to whom it refuses to pay fringe benefits. It previously classified these individuals as "independent contractors" or "freelancers," but prior to the filing of the action began classifying them as "temporary agency employees." Freelancers were hired when Microsoft needed to expand its workforce to meet the demands of new product schedules. The company did not, of course, provide them with any of the employee benefits regular employees receive.

The plaintiffs…performed services as software testers, production editors, proofreaders, formatters and indexers. Microsoft fully integrated the plaintiffs into its workforce: they often worked on teams along with regular employees, sharing the same supervisors, performing identical functions, and working the same core hours. Because Microsoft required that they work on site, they received admittance card keys, office equipment and supplies from the company.

Freelancers and regular employees, however, were not without their obvious distinctions. Freelancers wore badges of a different color, had different electronic-mail addresses, and attended a less formal orientation than that provided to regular employees. They were not permitted to assign their work to others, invited to official company functions, or paid overtime wages. In addition, they were not paid through Microsoft's payroll department. Instead, they submitted invoices for their services, documenting their hours and the projects on which they worked, and were paid through the accounts receivable department.

The plaintiffs were told when they were hired that, as freelancers, they would not be eligible for benefits. None has contended that Microsoft ever promised them any benefits individually. All eight named plaintiffs signed [employment agreements] when first hired by Microsoft or soon thereafter. [One] included a provision that states that the undersigned "agrees to be responsible for all federal and state taxes, withholding, social security, insurance and other benefits." The [other one] states that "as an Independent Contractor to Microsoft, you are self-employed and are responsible to pay all your own insurance and benefits." Eventually, the plaintiffs learned of the various benefits being provided to regular employees from speaking with them or reading various Microsoft publications concerning employee benefits.

In 1989 and 1990, the Internal Revenue Service (IRS)[,]…applying common-law principles defining the employer-employee relationship, concluded that Microsoft's freelancers were not independent contractors but employees for withholding and employment tax purposes, and that Microsoft would thereafter be required to pay withholding taxes and the employer's portion of Federal Insurance Contribution Act (FICA) tax. Microsoft agreed.…

After learning of the IRS rulings, the plaintiffs sought various employee benefits, including those now at issue: the ESPP and SPP benefits. The SPP…is a cash or deferred salary arrangement under § 401k of the Internal Revenue Code that permits Microsoft's employees to save and invest up to fifteen percent of their income through tax-deferred payroll deductions.…Microsoft matches fifty percent of the employee's contribution in any year, with [a maximum matching contribution]. The ESPP…permits employees to purchase company stock [with various rules].

Microsoft rejected the plaintiffs' claims for benefits, maintaining that they were independent contractors who were personally responsible for all their own benefits.…

The plaintiffs brought this action, challenging the denial of benefits.

Microsoft contends that the extrinsic evidence, including the [employment agreements], demonstrates its intent not to provide freelancers or independent contractors with employee benefits[.]…We have no doubt that the company did not intend to provide freelancers or independent contractors with employee benefits, and that if the plaintiffs had in fact been freelancers or independent contractors, they would not be eligible under the plan. The plaintiffs, however, were not freelancers or independent contractors. They were common-law employees, and the question is what, if anything, Microsoft intended with respect to persons who were actually common-law employees but were not known to Microsoft to be such. The fact that Microsoft did not intend to provide benefits to persons who it thought were freelancers or independent contractors sheds little or no light on that question.…

Microsoft's argument, drawing a distinction between common-law employees on the basis of the manner in which they were paid, is subject to the same vice as its more general argument. Microsoft regarded the plaintiffs as independent contractors during the relevant period and learned of their common-law-employee status only after the IRS examination. They were paid through the accounts receivable department rather than the payroll department because of Microsoft's mistaken view as to their legal status. Accordingly, Microsoft cannot now contend that the fact that they were paid through the accounts receivable department demonstrates that the company intended to deny them the benefits received by all common-law employees regardless of their actual employment status. Indeed, Microsoft has pointed to no evidence suggesting that it ever denied eligibility to any employees, whom it *understood* to be common-law employees, by paying them through the accounts receivable department or otherwise.

We therefore construe the ambiguity in the plan against Microsoft and hold that the plaintiffs are eligible to participate under the terms of the SPP.

[Next, regarding the ESPP] we hold that the plaintiffs…are covered by the specific provisions of the ESPP. We apply the "objective manifestation theory of contracts," which requires us to "impute an intention corresponding to the reasonable meaning of a person's words and acts." [Citation] Through its incorporation of the tax code provision into the plan, Microsoft manifested an objective intent to make all common-law employees, and hence the plaintiffs, eligible for participation. The ESPP specifically provides:

It is the intention of the Company to have the Plan qualify as an "employee stock purchase plan" under Section 423 of the Internal Revenue Code of 1954. *The provisions of the Plan shall, accordingly, be construed so as to extend and limit participation in a manner consistent with the requirements of that Section of the Code.* (emphasis added)

[T]he ESPP, when construed in a manner consistent with the requirements of § 423, extends participation to all common-law employees not covered by one of the express exceptions set forth in the plan. Accordingly, we find that the ESPP, through its incorporation of § 423, expressly extends eligibility for participation to the plaintiff class and affords them the same options to acquire stock in the corporation as all other employees.

Microsoft next contends that the [employment agreements] signed by the plaintiffs render them ineligible to participate in the ESPP. First, the label used in the instruments signed by the plaintiffs does not control their employment status. Second, the employment instruments, if construed to exclude the plaintiffs from receiving ESPP benefits, would conflict with the plan's express incorporation of § 423. Although Microsoft may have generally intended to exclude individuals who were in fact independent contractors, it could not, consistent with its express intention to extend participation in the ESPP to all common-law employees, have excluded the plaintiffs. Indeed, such an exclusion would defeat the purpose of including § 423 in the plan, because the exclusion of common-law employees not otherwise accepted would result in the loss of the plan's tax qualification.

Finally, Microsoft maintains that the plaintiffs are not entitled to ESPP benefits because the terms of the plan were never communicated to them and they were therefore unaware of its provisions when they performed their employment services.…In any event, to the extent that knowledge of an offer of benefits is a prerequisite, it is probably sufficient that Microsoft publicly promulgated the plan. In [Citation], the plaintiff was unaware of the company's severance plan until shortly before his termination. The Oklahoma Supreme Court concluded nonetheless that publication of the plan was "the equivalent of constructive knowledge on the part of *all* employees not specifically excluded."

We are not required to rely, however, on the [this] analysis or even on Microsoft's own unwitting concession. There is a compelling reason, implicit in some of the preceding discussion, that requires us to reject the company's theory that the plaintiffs' entitlement to ESPP benefits is defeated by their previous lack of knowledge regarding their rights. It is "well established" that an optionor may not rely on an optionee's failure to exercise an option when he has committed any act or failed to perform any duty "calculated to cause the optionee to delay in exercising the right." [Citation] "[T]he optionor may not make statements or representations calculated to cause delay, [or] fail to furnish [necessary] information.…" Similarly, "[I]t is a principle of fundamental justice that if a promisor is himself the cause of the failure of performance, either of an obligation due him or of a condition upon which his own liability depends, he cannot take advantage of the failure." [Citation]…

Applying these principles, we agree with the magistrate judge, who concluded that Microsoft, which created a benefit to which the plaintiffs were entitled, could not defend itself by arguing that the plaintiffs were unaware of the benefit, when its own false representations precluded them from gaining that knowledge. Because Microsoft misrepresented both the plaintiffs' actual employment status and their eligibility to participate in the ESPP, it is responsible for their failure to know that they were covered

by the terms of the offer. It may not now take advantage of that failure to defeat the plaintiffs' rights to ESPP benefits. Thus, we reject Microsoft's final argument.

Conclusion

For the reasons stated, the district court's grant of summary judgment in favor of Microsoft and denial of summary judgment in favor of the plaintiffs is REVERSED and the case REMANDED for the determination of any questions of individual eligibility for benefits that may remain following issuance of this opinion and for calculation of the damages or benefits due the various class members.

? Case Questions

1. In a 1993 *Wall Street Journal* article, James Bovard asserted that the IRS "is carrying out a sweeping campaign to slash the number of Americans permitted to be self-employed—and to punish the companies that contract with them…IRS officials indicate that more than half the nation's self-employed should no longer be able to work for themselves." Why did Microsoft want these employees to "be able to work for themselves"?
2. Why did the employees accept employment as independent contractors?
3. It seems unlikely that the purpose of the IRS's campaign was really to keep people from working for themselves, despite Mr. Bovard's assumption. What was the purpose of the campaign?
4. Why did the IRS and the court determine that these "independent contractors" were in fact employees?

Breach of Fiduciary Duty

Bacon v. Volvo Service Center, Inc.

597 S.E.2d 440 (Ga. App. 2004)

Smith, J.

[This appeal is] taken in an action that arose when two former employees left an existing business and began a new, competing business.…Bacon and Johnson, two former employees of Volvo Service Center, Inc. (VSC), and the new company they formed, South Gwinnett Volvo Service, Ltd. (SGVS), appeal from the trial court's denial of their motion for judgment notwithstanding the jury's verdict in favor of VSC.…

VSC filed suit against appellants, alleging a number of claims arising from the use by Bacon, who had been a service technician at VSC, of VSC's customer list, and his soliciting Johnson, a service writer, and another VSC employee to join SGVS. SGVS moved for a directed verdict on certain claims at the close of plaintiff's evidence and at the close of the case, which motions were denied. The jury was asked to respond to specific interrogatories, and it found for VSC and against all three appellants on VSC's claim for misappropriation of trade secrets. The jury also found for plaintiff against Bacon for breach of fiduciary duty,…tortious interference with business relations, employee piracy, and conversion of corporate assets. The jury awarded VSC attorney fees, costs, and exemplary damages stemming from the claim for misappropriation of trade secrets. Judgment was entered on the jury's verdict, and appellants' motion for j.n.o.v. was denied. This appeal ensued. We find that VSC did not meet its burden of proof as to the claims for misappropriation of trade secrets, breach of fiduciary duty, or employee piracy, and the trial court should have granted appellants' motion for j.n.o.v.

Construed to support the jury's verdict, the evidence of record shows that Bacon was a technician at VSC when he decided to leave and open a competing business. Before doing so, he printed a list of VSC's customers from one of VSC's two computers. Computer access was not password restricted, was easy to use, and was used by many employees from time to time.

About a year after he left VSC, Bacon gave Johnson and another VSC employee an offer of employment at his new Volvo repair shop, which was about to open. Bacon and Johnson advertised extensively, and the customer list was used to send flyers to some VSC customers who lived close to the new shop's location. These activities became the basis for VSC's action against Bacon, Johnson, and their new shop, SGVS.…

1. The Georgia Trade Secrets Act of 1990, [Citation], defines a "trade secret" as

information, without regard to form, including, but not limited to,…a list of actual or potential customers or suppliers which is not commonly known by or available to the public and which information:

(A) Derives economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and

(B) Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

If an employer does not prove both prongs of this test, it is not entitled to protection under the Act. Our Supreme Court held in [Citation, 1991] for instance, that information was not a trade secret within the meaning of the Act because no evidence showed that the employer "made reasonable efforts under the circumstances…to maintain the confidentiality of the information it sought to protect."

While a client list may be subject to confidential treatment under the Georgia Trade Secrets Act, the information itself is not inherently confidential. Customers are not trade secrets. Confidentiality is afforded only where the customer list is not generally known or ascertainable from other sources and was the subject of reasonable efforts to maintain its secrecy.…

Here, VSC took *no* precautions to maintain the confidentiality of its customer list. The information was on both computers, and it was not password-protected. Moreover, the same information was available to the technicians through the repair orders, which they were permitted to retain indefinitely while Bacon was employed there. Employees were not informed that the information was confidential. Neither Bacon nor Johnson was required to sign a confidentiality agreement as part of his employment.

Because no evidence was presented from which the jury could have concluded that VSC took any steps, much less reasonable ones, to protect the confidentiality of its customer list, a material requirement for trade secret status was not satisfied. The trial court should have granted appellants' motion for j.n.o.v.

2. To prove tortious interference with business relations, "a plaintiff must show defendant: (1) acted improperly and without privilege, (2) acted purposely and with malice with the intent to injure, (3) induced a third party or parties not to enter into or continue a business relationship with the plaintiff, and (4) caused plaintiff financial injury." [Citation] But "[f]air competition is always legal." [Citations] Unless an employee has executed a valid non-compete or non-solicit covenant, he is not barred from soliciting customers of his former employer on behalf of a new employer. [Citation]

No evidence was presented that Bacon acted "improperly," that any of VSC's former customers switched to SGVS because of any improper act by Bacon, or that these customers would have continued to patronize VSC but for Bacon's solicitations. Therefore, it was impossible for a jury to calculate VSC's financial damage, if any existed.

3. With regard to VSC's claim for breach of fiduciary duty, "[a]n employee breaches no fiduciary duty to the employer simply by making plans to enter a competing business while he is still employed. Even before the termination of his agency, he is entitled to make arrangements to compete and upon termination of employment immediately compete." [Citation] He cannot solicit customers for a rival business or do other, similar acts in direct competition with his employer's business before his employment ends. But here, no evidence was presented to rebut the evidence given by Bacon and Johnson that they engaged in no such practices before their employment with VSC ended. Even assuming, therefore, that a fiduciary relationship existed, no evidence was presented showing that it was breached.

4. The same is true for VSC's claim for employee piracy. The evidence simply does not show that any employees of VSC were solicited for SGVS before Bacon left VSC's employ.…

Judgment reversed.

? Case Questions

1. Why was it determined that the defendants were not liable for any breach of trade secrecy?
2. What would have been necessary to show tortious interference with business relations?
3. The evidence was lacking that there was any breach of fiduciary duty. What would have been necessary to show that?
4. What is "employee piracy"? Why was it not proven?

Workers' Compensation: What "Injuries" Are Compensable?

Wolfe v. Sibley, Lindsay & Curr Co.

330 N.E.2d 603 (N.Y. 1975)

Wachtler, J.

This appeal involves a claim for workmen's compensation benefits for the period during which the claimant was incapacitated by severe depression caused by the discovery of her immediate supervisor's body after he had committed suicide.

The facts as adduced at a hearing before the Workmen's Compensation Board are uncontroverted. The claimant, Mrs. Diana Wolfe, began her employment with the respondent department store, Sibley, Lindsay & Curr Co. in February, 1968. After working for some time as an investigator in the security department of the store she became secretary to Mr. John Gorman, the security director. It appears from the record that as head of security, Mr. Gorman was subjected to intense pressure, especially during the Christmas holidays. Mrs. Wolfe testified that throughout the several years she worked at Sibley's Mr. Gorman reacted to this holiday pressure by becoming extremely agitated and nervous. She noted, however, that this anxiety usually disappeared when the holiday season was over. Unfortunately, Mr. Gorman's nervous condition failed to abate after the 1970 holidays.…

Despite the fact that he followed Mrs. Wolfe's advice to see a doctor, Mr. Gorman's mental condition continued to deteriorate. On one occasion he left work at her suggestion because he appeared to be so nervous. This condition persisted until the morning of June 9, 1971 when according to the claimant, Mr. Gorman looked much better and even smiled and 'tousled her hair' when she so remarked.

A short time later Mr. Gorman called her on the intercom and asked her to call the police to room 615. Mrs. Wolfe complied with this request and then tried unsuccessfully to reach Mr. Gorman on the intercom. She entered his office to find him lying in a pool of blood caused by a self-inflicted gunshot wound in the head. Mrs. Wolfe became extremely upset and was unable to continue working that day.

She returned to work for one week only to lock herself in her office to avoid the questions of her fellow workers. Her private physician perceiving that she was beset by feelings of guilt referred her to a psychiatrist and recommended that she leave work, which she did. While at home she ruminated about her guilt in failing to prevent the suicide and remained in bed for long periods of time staring at the ceiling. The result was that she became unresponsive to her husband and suffered a weight loss of 20 pounds. Her psychiatrist, Dr. Grinols diagnosed her condition as an acute depressive reaction.

After attempting to treat her in his office Dr. Grinols realized that the severity of her depression mandated hospitalization. Accordingly, the claimant was admitted to the hospital on July 9, 1971 where she remained for two months during which time she received psychotherapy and medication. After she was discharged, Dr. Grinols concluded that there had been no substantial remission in her depression and ruminative guilt and so had her readmitted for electroshock treatment. These treatments lasted for three weeks and were instrumental in her recovery. She was again discharged and, in mid-January, 1972, resumed her employment with Sibley, Lindsay & Curr.

Mrs. Wolfe's claim for workmen's compensation was granted by the referee and affirmed by the Workmen's Compensation Board. On appeal the Appellate Division reversed citing its opinions in [Citations], [concluding]…that mental injury precipitated solely by psychic trauma is not compensable as a matter of law. We do not agree with this conclusion.

Workmen's compensation, as distinguished from tort liability which is essentially based on fault, is designed to shift the risk of loss of earning capacity caused by industrial accidents from the worker to industry and ultimately the consumer. In light of its beneficial and remedial character the Workmen's Compensation Law should be construed liberally in favor of the employee [Citation].

Liability under the act is predicated on accidental injury arising out of and in the course of employment.…Applying these concepts to the case at bar we note that there is no issue raised concerning the causal relationship between the occurrence and the injury. The only testimony on this matter was given by Dr. Grinols who stated unequivocally that the discovery of her superior's body was the competent producing cause of her condition. Nor is there any question as to the absence of physical impact. Accordingly, the focus of our inquiry is whether or not there has been an accidental injury within the meaning of the Workmen's Compensation Law.

Since there is no statutory definition of this term we turn to the relevant decisions. These may be divided into three categories: (1) psychic trauma which produces physical injury, (2) physical impact which produces psychological injury, and (3) psychic trauma

which produces psychological injury. As to the first class our court has consistently recognized the principle that an injury caused by emotional stress or shock may be accidental within the purview of the compensation law. [Citation] Cases falling into the second category have uniformly sustained awards to those incurring nervous or psychological disorders as a result of physical impact [Citation]. As to those cases in the third category the decisions are not as clear.…

We hold today that psychological or nervous injury precipitated by psychic trauma is compensable to the same extent as physical injury. This determination is based on two considerations. First, as noted in the psychiatric testimony there is nothing in the nature of a stress or shock situation which ordains physical as opposed to psychological injury. The determinative factor is the particular vulnerability of an individual by virtue of his physical makeup. In a given situation one person may be susceptible to a heart attack while another may suffer a depressive reaction. In either case the result is the same—the individual is incapable of functioning properly because of an accident and should be compensated under the Workmen's Compensation Law.

Secondly, having recognized the reliability of identifying psychic trauma as a causative factor of injury in some cases and the reliability by identifying psychological injury as a resultant factor in other cases, we see no reason for limiting recovery in the latter instance to cases involving physical impact. There is nothing talismanic about physical impact.

We would note in passing that this analysis reflects the view of the majority of jurisdictions in this country and England. [Citations]…

Accordingly, the order appealed from should be reversed and the award to the claimant reinstated, with costs.

? Case Questions

1. Why did the appeals court deny workers' compensation benefits for Wolfe?
2. On what reasoning did the New York high court reverse?
3. There was a dissent in this case (not included here). Judge Breitel noted that the evidence was that Mrs. Wolfe had a psychological condition such that her trauma "could never have occurred unless she, to begin with, was extraordinarily vulnerable to severe shock at or away from her place of employment or one produced by accident or injury to those close to her in employment or in her private life." The judge worried that "one can easily call up a myriad of commonplace occupational pursuits where employees are often exposed to the misfortunes of others which may in the mentally unstable evoke precisely the symptoms which this claimant suffered." He concluded, "In an era marked by examples of overburdening of socially desirable programs with resultant curtailment or destruction of such programs, a realistic assessment of impact of doctrine is imperative. An overburdening of the compensation system by injudicious and open-ended expansion of compensation benefits, especially for costly, prolonged, and often only ameliorative psychiatric care, cannot but threaten its soundness or that of the enterprises upon which it depends." What is the concern here?

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9.4: Summary and Exercises

Summary

An agent is one who acts on behalf of another. The law recognizes several types of agents, including (1) the general agent, one who possesses authority to carry out a broad range of transactions in the name of and on behalf of the principal; (2) the special agent, one with authority to act only in a specifically designated instance or set of transactions; (3) the agent whose agency is coupled with an interest, one who has a property interest in addition to authority to act as an agent; (4) the subagent, one appointed by an agent with authority to do so; and (5) the servant ("employee" in modern English), one whose physical conduct is subject to control of the principal.

A servant should be distinguished from an independent contractor, whose work is not subject to the control of the principal. The difference is important for purposes of taxation, workers' compensation, and liability insurance.

The agency relationship is usually created by contract, and sometimes governed by the Statute of Frauds, but some agencies are created by operation of law.

An agent owes his principal the highest duty of loyalty, that of a fiduciary. The agent must avoid self-dealing, preserve confidential information, perform with skill and care, conduct his personal life so as not to bring disrepute on the business for which he acts as agent, keep and render accounts, and give appropriate information to the principal.

Although the principal is not the agent's fiduciary, the principal does have certain obligations toward the agent—for example, to refrain from interfering with the agent's work and to indemnify. The employer's common-law tort liability toward his employees has been replaced by the workers' compensation system, under which the employee gives up the right to sue for damages in return for prompt payment of medical and job-loss expenses. Injuries must have been work related and the injured person must have been an employee. Courts today allow awards for psychological trauma in the absence of physical injury.

Exercises

1. A woman was involved in an automobile accident that resulted in the death of a passenger in her car. After she was charged with manslaughter, her attorney agreed to work with her insurance company's claims adjuster in handling the case. As a result of the agreement, the woman gave a statement about the accident to the claims adjuster. When the prosecuting attorney demanded to see the statement, the woman's attorney refused on the grounds that the claims adjuster was his—the attorney's—agent, and therefore the statement was covered by the attorney-client privilege. Is the attorney correct? Why?
2. A local hotel operated under a franchise agreement with a major hotel chain. Several customers charged the banquet director of the local hotel with misconduct and harassment. They sued the hotel chain (the franchisor) for acts committed by the local hotel (the franchisee), claiming that the franchisee was the agent of the franchisor. Is an agency created under these circumstances? Why?
3. A principal hired a mortgage banking firm to obtain a loan commitment of $10,000,000 from an insurance company for the construction of a shopping center. The firm was promised a fee of $50,000 for obtaining the commitment. The firm was successful in arranging for the loan, and the insurance company, without the principal's knowledge, agreed to pay the firm a finder's fee. The principal then refused to pay the firm the promised $50,000, and the firm brought suit to recover the fee. May the firm recover the fee? Why?
4. Based on his experience working for the CIA, a former CIA agent published a book about certain CIA activities in South Vietnam. The CIA did not approve of the publication of the book although, as a condition of his employment, the agent had agreed not to publish any information relating to the CIA without specific approval of the agency. The government brought suit against the agent, claiming that all the agent's profits from publishing the book should go to the government. Assuming that the government suffered only nominal damages because the agent published no classified information, will the government prevail? Why?
5. Upon graduation from college, Edison was hired by a major chemical company. During the time when he was employed by the company, Edison discovered a synthetic oil that could be manufactured at a very low cost. What rights, if any, does Edison's employer have to the discovery? Why?
6. A US company hired MacDonald to serve as its resident agent in Bolivia. MacDonald entered into a contract to sell cars to Bolivia and personally guaranteed performance of the contract as required by Bolivian law. The cars delivered to Bolivia were

defective, and Bolivia recovered a judgment of $83,000 from MacDonald. Must the US company reimburse MacDonald for this amount? Explain.

7. According to the late Professor William L. Prosser, “The theory underlying the workmen’s compensation acts never has been stated better than in the old campaign slogan, ‘The cost of the product should bear the blood of the workman.’” What is meant by this statement?
8. An employee in a Rhode Island foundry inserted two coins in a coin-operated coffee machine in the company cafeteria. One coin stuck in the machine, and the worker proceeded to “whack” the machine with his right arm. The arm struck a grate near the machine, rupturing the biceps muscle and causing a 10 percent loss in the use of the arm. Is the worker entitled to workers’ compensation? Explain.
9. Paulson engaged Arthur to sell Paul’s restored 1948 Packard convertible to Byers for $23,000. A few days later, Arthur saw an advertisement showing that Collector was willing to pay $30,000 for a 1948 Packard convertible in “restored” condition. Arthur sold the car to Byers, and subsequently Paulson learned of Collector’s interest. What rights, if any, has Paulson against Arthur?

SELF CHECK QUESTIONS

1. One who has authority to act only in a specifically designated instance or in a specifically designated set of transactions is called
    1. a subagent
    2. a general agent
    3. a special agent
    4. none of the above
2. An agency relationship may be created by
    1. contract
    2. operation of law
    3. an oral agreement
    4. all of the above
3. An agent’s duty to the principal includes
    1. the duty to indemnify
    2. the duty to warn of special dangers
    3. the duty to avoid self dealing
    4. all of the above
4. A person whose work is not subject to the control of the principal, but who arranges to perform a job for him is called
    1. a subagent
    2. a servant
    3. a special agent
    4. an independent contractor
5. An employer’s liability for employees’ on-the-job injuries is generally governed by
    1. tort law
    2. the workers’ compensation system
    3. Social Security
    4. none of the above

AnswerS

1. c
2. d
3. c
4. d
5. b

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CHAPTER OVERVIEW

10: Liability of Principal and Agent; Termination of Agency

Learning Objectives

After reading this chapter, you should understand the following:

- The principal's liability in contract
- The principal's liability in tort
- The principal's criminal liability
- The agent's personal liability in tort and contract
- How agency relationships are terminated

In this chapter we focus on the relationships between third parties and the principal or agent. When the agent makes a contract for his principal or commits a tort in the course of his work, is the principal liable? What is the responsibility of the agent for torts committed and contracts entered into on behalf of his principal? How may the relationship be terminated so that the principal or agent will no longer have responsibility toward or liability for the acts of the other? These are the questions addressed in this chapter.

10.1: Principal's Contract Liability

10.2: Principal's Tort and Criminal Liability

10.3: Agent's Personal Liability for Torts and Contracts; Termination of Agency

10.4: Cases

10.5: Summary and Exercises

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10.1: Principal's Contract Liability

Learning Objectives

By the end of this section, you will be able to:

- Understand that the principal's liability depends on whether the agent was authorized to make the contract.
- Recognize how the agent's authority is acquired: expressly, impliedly, or apparently.
- Know that the principal may also be liable—even if the agent had no authority—if the principal ratifies the agent's contract after the fact.

Principal's Contract Liability Requires That Agent Had Authority

The key to determining whether a principal is liable for contracts made by his agent is authority: was the agent authorized to negotiate the agreement and close the deal? Obviously, it would not be sensible to hold a contractor liable to pay for a whole load of lumber merely because a stranger wandered into the lumberyard saying, "I'm an agent for ABC Contractors; charge this to their account." To be liable, the principal must have authorized the agent in some manner to act in his behalf, and that authorization must be communicated to the third party by the principal.

Types of Authority

There are three types of authority: express, implied, and apparent (see Figure 15.1). We will consider each in turn.

Express Authority

The strongest form of authority is that which is expressly granted, often in written form. The principal consents to the agent's actions, and the third party may then rely on the document attesting to the agent's authority to deal on behalf of the principal. One common form of express authority is the standard signature card on file with banks allowing corporate agents to write checks on the company's credit. The principal bears the risk of any wrongful action of his agent, as demonstrated in *Allen A. Funt Productions, Inc. v. Chemical Bank.Allen A. Funt Productions, Inc. v. Chemical Bank*, 405 N.Y.S.2d 94 (1978). Allen A. Funt submitted to his bank through his production company various certificates permitting his accountant to use the company's checking accounts.Allen Funt (1914–99) was an American television producer, director, and writer, best known as the creator and host of *Candid Camera* from the 1940s to 1980s, which was broadcast as either a regular show or a series of specials. Its most notable run was from 1960 to 1967 on CBS. In fact, for several years the accountant embezzled money from the company by writing checks to himself and depositing them in his own account. The company sued its bank, charging it with negligence, apparently for failing to monitor the amount of money taken by the accountant. But the court dismissed the negligence complaint, citing a state statute based on the common-law agency principle that a third party is entitled to rely on the express authorization given to an agent; in this case, the accountant drew checks on the account within the monetary limits contained in the signature cards on file with the bank. Letters of introduction and work orders are other types of express authority.

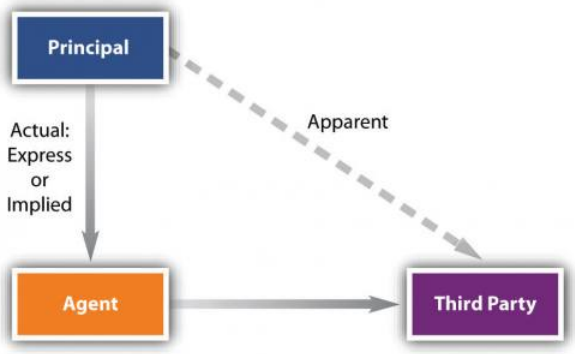


Figure 15.1 Types of Authority

Implied Authority

Not every detail of an agent's work can be spelled out. It is impossible to delineate step-by-step the duties of a general agent; at best, a principal can set forth only the general nature of the duties that the agent is to perform. Even a special agent's duties are difficult to describe in such detail as to leave him without discretion. If express authority were the only valid kind, there would be no efficient way to use an agent, both because the effort to describe the duties would be too great and because the third party would be reluctant to deal with him.

But the law permits authority to be "implied" by the relationship of the parties, the nature and customs of the business, the circumstances surrounding the act in question, the wording of the agency contract, and the knowledge that the agent has of facts relevant to the assignment. The general rule is that the agent has implied or "incidental" authority to perform acts incidental to or reasonably necessary to carrying out the transaction. Thus if a principal instructs her agent to "deposit a check in the bank today," the agent has authority to drive to the bank unless the principal specifically prohibits the agent from doing so.

The theory of implied authority is especially important to business in the realm of the business manager, who may be charged with running the entire business operation or only a small part of it. In either event, the business manager has a relatively large domain of implied authority. He can buy goods and services; hire, supervise, and fire employees; sell or junk inventory; take in receipts and pay debts; and in general, direct the ordinary operations of the business. The full extent of the manager's authority depends on the circumstances—what is customary in the particular industry, in the particular business, and among the individuals directly concerned.

On the other hand, a manager does not have implicit authority to undertake unusual or extraordinary actions on behalf of his principal. In the absence of express permission, an agent may not sell part of the business, start a new business, change the nature of the business, incur debt (unless borrowing is integral to the business, as in banking, for example), or move the business premises. For example, the owner of a hotel appoints Andy manager; Andy decides to rename the hotel and commissions an artist to prepare a new logo for the hotel's stationery. Andy has no implied authority to change the name or to commission the artist, though he does have implied authority to engage a printer to replenish the stationery supply—and possibly to make some design changes in the letterhead.

Even when there is no implied authority, in an emergency the agent may act in ways that would in the normal course require specific permission from the principal. If unforeseen circumstances arise and it is impracticable to communicate with the principal to find out what his wishes would be, the agent may do what is reasonably necessary in order to prevent substantial loss to his principal. During World War II, Eastern Wine Corporation marketed champagne in a bottle with a diagonal red stripe that infringed the trademark of a French producer. The French company had granted licenses to an American importer to market its champagne in the United States. The contract between producer and importer required the latter to notify the French company whenever a competitor appeared to be infringing its rights and to recommend steps by which the company could stop the infringement. The authority to institute suit was not expressly conferred, and ordinarily the right to do so would not be inferred. Because France was under German occupation, however, the importer was unable to communicate with the producer, its principal. The court held that the importer could file suit to enjoin Eastern Wine from continuing to display the infringing red diagonal stripe, since legal action was "essential to the preservation of the principal's property."*G. H. Mumm Champagne v. Eastern Wine Corp.*, 52 F.Supp. 167 (S.D.N.Y. 1943).

The rule that a person's position can carry with it implied authority is fundamental to American business practice. But outside the United States this rule is not applicable, and the business executive traveling abroad should be aware that in civil-law countries it is customary to present proof of authority to transact corporate business—usually in the form of a power of attorney. This is not always an easy task. Not only must the power of the traveling executive be shown but the right of the corporate officer back in the United States to delegate authority must also be proven.

Apparent Authority

In the agency relationship, the agent's actions in dealing with third parties will affect the legal rights of the principal. What the third party knows about the agency agreement is irrelevant to the agent's legal authority to act. That authority runs from principal to agent. As long as an agent has authorization, either express or implied, she may bind the principal legally. Thus the seller of a house may be ignorant of the buyer's true identity; the person he supposes to be the prospective purchaser might be the agent of an

undisclosed principal. Nevertheless, if the agent is authorized to make the purchase, the seller's ignorance is not a ground for either seller or principal to void the deal.

But if a person has no authority to act as an agent, or an agent has no authority to act in a particular way, is the principal free from all consequences? The answer depends on whether or not the agent has apparent authority—that is, on whether or not the third person reasonably believes from the principal's words, written or spoken, or from his conduct that he has in fact consented to the agent's actions. Apparent authority is a manifestation of authority communicated to the third person; it runs from principal to third party, not to the agent.

Apparent authority is sometimes said to be based on the principle of estoppel. Estoppel is the doctrine that a person will not now be allowed to deny a promise or assertion she previously made where there has been detrimental reliance on that promise or assertion. Estoppel is commonly used to avoid injustice. It may be a substitute for the requirement of consideration in contract (making the promise of a gift enforceable where the donee has relied upon the promise), and it is sometimes available to circumvent the requirement of a writing under the Statute of Frauds.

Apparent authority can arise from prior business transactions. On July 10, Meggs sold to Buyer his business, the right to use the trade name Rose City Sheet Metal Works, and a list of suppliers he had used. Three days later, Buyer began ordering supplies from Central Supply Company, which was on Meggs's list but with which Meggs had last dealt four years before. On September 3, Central received a letter from Meggs notifying it of Meggs's sale of the business to Buyer. Buyer failed to pay Central, which sued Meggs. The court held that Rose City Sheet Metal Works had apparent authority to buy on Meggs's credit; Meggs was liable for supplies purchased between July 10 and September 3.*Meggs v. Central Supply Co.*, 307 N.E.2d 288 (Ind. App. 1974). In such cases, and in cases involving the firing of a general manager, actual notice should be given promptly to all customers. See the discussion of *Kanavos v. Hancock Bank & Trust Company* in Section 15.4.1 "Implied Authority".

Ratification

Even if the agent possessed no actual authority and there was no apparent authority on which the third person could rely, the principal may still be liable if he ratifies or adopts the agent's acts before the third person withdraws from the contract. Ratification usually relates back to the time of the undertaking, creating authority after the fact as though it had been established initially. Ratification is a voluntary act by the principal. Faced with the results of action purportedly done on his behalf but without authorization and through no fault of his own, he may affirm or disavow them as he chooses. To ratify, the principal may tell the parties concerned or by his conduct manifest that he is willing to accept the results as though the act were authorized. Or by his silence he may find under certain circumstances that he has ratified. Note that ratification does not require the usual consideration of contract law. The principal need be promised nothing extra for his decision to affirm to be binding on him. Nor does ratification depend on the position of the third party; for example, a loss stemming from his reliance on the agent's representations is not required. In most situations, ratification leaves the parties where they expected to be, correcting the agent's errors harmlessly and giving each party what was expected.

Key Takeaway

The principal is liable on an agent's contract only if the agent was authorized by the principal to make the contract. Such authority is express, implied, or apparent. *Express* means made in words, orally or in writing; *implied* means the agent has authority to perform acts incidental to or reasonably necessary to carrying out the transaction for which she has express authority. *Apparent authority* arises where the principal gives the third party reason to believe that the agent had authority. The reasonableness of the third party's belief is based on all the circumstances—all the facts. Even if the agent has no authority, the principal may, after the fact, ratify the contract made by the agent.

Exercises

1. Could express authority be established by silence on the part of the principal?
2. Why is the concept of implied authority very important in business situations?
3. What is the rationale for the doctrine of apparent authority—that is, why would the law impose a contract on a "principal" when in fact there was no principal-agent relationship with the "agent" at all?

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10.2: Principal's Tort and Criminal Liability

Learning Objectives

By the end of this section, you will be able to:

- Understand in what circumstances a principal will be vicariously liable for torts committed by employees.
- Recognize the difference between agents whose tort and criminal liability may be imputed to the employer and those whose liability will not be so imputed.
- Know when the principal will be vicariously liable for intentional torts committed by the agent.
- Explain what is meant by "the scope of employment," within which the agent's actions may be attributed to the principal and without which they will not.
- Name special cases of vicarious liability.
- Describe the principal's liability for crimes committed by the agent.

Principal's Tort Liability

The Distinction between Direct and Vicarious Liability

When is the principal liable for injuries that the agent causes another to suffer?

Direct Liability

There is a distinction between torts prompted by the principal himself and torts of which the principal was innocent. If the principal directed the agent to commit a tort or knew that the consequences of the agent's carrying out his instructions would bring harm to someone, the principal is liable. This is an application of the general common-law principle that one cannot escape liability by delegating an unlawful act to another. The syndicate that hires a hitman is as culpable of murder as the man who pulls the trigger. Similarly, a principal who is negligent in his use of agents will be held liable for their negligence. This rule comes into play when the principal fails to supervise employees adequately, gives faulty directions, or hires incompetent or unsuitable people for a particular job. Imposing liability on the principal in these cases is readily justifiable since it is the principal's own conduct that is the underlying fault; the principal here is directly liable.

Vicarious Liability

But the principle of liability for one's agent is much broader, extending to acts of which the principal had no knowledge, that he had no intention to commit nor involvement in, and that he may in fact have expressly prohibited the agent from engaging in. This is the principle of respondeat superior ("let the master answer") or the master-servant doctrine, which imposes on the principal vicarious liability (*vicarious* means "indirectly, as, by, or through a substitute") under which the principal is responsible for acts committed by the agent within the scope of the employment (see Figure 15.2).

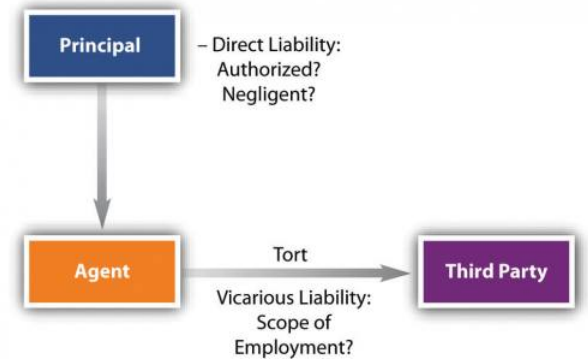


Figure 15.2 Principal's Tort Liability

The modern basis for vicarious liability is sometimes termed the "deep pocket" theory: the principal (usually a corporation) has deeper pockets than the agent, meaning that it has the wherewithal to pay for the injuries traceable one way or another to events it

set in motion. A million-dollar industrial accident is within the means of a company or its insurer; it is usually not within the means of the agent—employee—who caused it.

The "deep pocket" of the defendant-company is not always very deep, however. For many small businesses, in fact, the principle of respondeat superior is one of life or death. One example was the closing in San Francisco of the much-beloved Larraburu Brothers Bakery—at the time, the world's second largest sourdough bread maker. The bakery was held liable for $2 million in damages after one of its delivery trucks injured a six-year-old boy. The bakery's insurance policy had a limit of $1.25 million, and the bakery could not absorb the excess. The Larraburus had no choice but to cease operations. (See http://www.outsidelands.org/larraburu.php.)

Respondeat superior raises three difficult questions: (1) What type of agents can create tort liability for the principal? (2) Is the principal liable for the agent's intentional torts? (3) Was the agent acting within the scope of his employment? We will consider these questions in turn.

Agents for Whom Principals Are Vicariously Liable

In general, the broadest liability is imposed on the master in the case of tortious physical conduct by a servant, as discussed in Chapter 14. If the servant acted within the scope of his employment—that is, if the servant's wrongful conduct occurred while performing his job—the master will be liable to the victim for damages unless, as we have seen, the victim was another employee, in which event the workers' compensation system will be invoked. Vicarious tort liability is primarily a function of the employment relationship and not agency status.

Ordinarily, an individual or a company is not vicariously liable for the tortious acts of independent contractors. The plumber who rushes to a client's house to repair a leak and causes a traffic accident does not subject the homeowner to liability. But there are exceptions to the rule. Generally, these exceptions fall into a category of duties that the law deems nondelegable. In some situations, one person is obligated to provide protection to or care for another. The failure to do so results in liability whether or not the harm befell the other because of an independent contractor's wrongdoing. Thus a homeowner has a duty to ensure that physical conditions in and around the home are not unreasonably dangerous. If the owner hires an independent contracting firm to dig a sewer line and the contractor negligently fails to guard passersby against the danger of falling into an open trench, the homeowner is liable because the duty of care in this instance cannot be delegated. (The contractor is, of course, liable to the homeowner for any damages paid to an injured passerby.)

Liability for Agent's Intentional Torts

In the nineteenth century, a principal was rarely held liable for intentional wrongdoing by the agent if the principal did not command the act complained of. The thought was that one could never infer authority to commit a willfully wrongful act. Today, liability for intentional torts is imputed to the principal if the agent is acting to further the principal's business. See the very disturbing *Lyon v. Carey* in Section 15.4.2 "Employer's Liability for Employee's Intentional Torts: Scope of Employment".

Deviations from Employment

The general rule is that a principal is liable for torts only if the servant committed them "in the scope of employment." But determining what this means is not easy.

The "Scope of Employment" Problem

It may be clear that the person causing an injury is the agent of another. But a principal cannot be responsible for every act of an agent. If an employee is following the letter of his instructions, it will be easy to determine liability. But suppose an agent deviates in some way from his job. The classic test of liability was set forth in an 1833 English case, *Joel v. Morrison.Joel v. Morrison*, 6 Carrington & Payne 501. The plaintiff was run over on a highway by a speeding cart and horse. The driver was the employee of another, and inside was a fellow employee. There was no question that the driver had acted carelessly, but what he and his fellow employee were doing on the road where the plaintiff was injured was disputed. For weeks before and after the accident, the cart had never been driven in the vicinity in which the plaintiff was walking, nor did it have any business there. The suggestion was that the employees might have gone out of their way for their own purposes. As the great English jurist Baron Parke put it, "If the servants, being on their master's business, took a detour to call upon a friend, the master will be responsible.…But if he was going on a

frolic of his own, without being at all on his master's business, the master will not be liable." In applying this test, the court held the employer liable.

The test is thus one of degree, and it is not always easy to decide when a detour has become so great as to be transformed into a frolic. For a time, a rather mechanical rule was invoked to aid in making the decision. The courts looked to the servant's purposes in "detouring." If the servant's mind was fixed on accomplishing his own purposes, then the detour was held to be outside the scope of employment; hence the tort was not imputed to the master. But if the servant also intended to accomplish his master's purposes during his departure from the letter of his assignment, or if he committed the wrong while returning to his master's task after the completion of his frolic, then the tort was held to be within the scope of employment.

This test is not always easy to apply. If a hungry deliveryman stops at a restaurant outside the normal lunch hour, intending to continue to his next delivery after eating, he is within the scope of employment. But suppose he decides to take the truck home that evening, in violation of rules, in order to get an early start the next morning. Suppose he decides to stop by the beach, which is far away from his route. Does it make a difference if the employer knows that his deliverymen do this?

The Zone of Risk Test

Court decisions in the last forty years have moved toward a different standard, one that looks to the foreseeability of the agent's conduct. By this standard, an employer may be held liable for his employee's conduct even when devoted entirely to the employee's own purposes, as long as it was foreseeable that the agent might act as he did. This is the "zone of risk" test. The employer will be within the zone of risk for vicarious liability if the employee is where she is supposed to be, doing—more or less—what she is supposed to be doing, and the incident arose from the employee's pursuit of the employer's interest (again, more or less). That is, the employer is within the zone of risk if the servant is in the place within which, if the master were to send out a search party to find a missing employee, it would be reasonable to look. See Section 4, *Cockrell v. Pearl River Valley Water Supply Dist.*

Special Cases of Vicarious Liability

Vicarious liability is not limited to harm caused in the course of an agency relationship. It may also be imposed in other areas, including torts of family members, and other torts governed by statute or regulation. We will examine each in turn.

Use of Automobiles

A problem commonly arises when an automobile owner lends his vehicle to a personal friend, someone who is not an agent, and the borrower injures a third person. Is the owner liable? In many states, the owner is not liable; in other states, however, two approaches impose liability on the owner.

The first approach is legislative: owner's consent statutes make the owner liable when the automobile is being driven with his consent or knowledge. The second approach to placing liability on the owner is judicial and known as the family purpose doctrine. Under this doctrine, a family member who negligently injures someone with the car subjects the owner to liability if the family member was furthering family purposes. These are loosely defined to include virtually every use to which a child, for example, might put a car. In a Georgia case, *Dixon v. Phillips*, the father allowed his minor son to drive the car but expressly forbade him from letting anyone else do so.*Dixon v. Phillips*, 217 S.E.2d 331 (Ga. 1975). Nevertheless, the son gave the wheel to a friend and a collision occurred while both were in the car. The court held the father liable because he made the car available for the pleasure and convenience of his son and other family members.

Torts of Family Members

At common law, the husband was liable for the torts of his wife, not because she was considered an agent but because she was considered to be an extension of him. "Husband and wife were only one person in law,"O.W. Holmes, *Agency*, 4 Harvard Law Rev. 353 (1890–91). says Holmes, and any act of the wife was supposed to have been done at the husband's direction (to which Mr. Dickens's Mr. Bumble responded, in the memorable line, "If the law supposes that, the law is a ass—a idiot"Charles Dickens, *Oliver Twist*, (London: 1838), chap 51.). This ancient view has been abrogated by statute or by court ruling in all the states, so that now a wife is solely responsible for her own torts unless she in fact serves as her husband's agent.

Unlike wives, children are not presumed at common law to be agents or extensions of the father so that normally parents are not vicariously liable for their children's torts. However, they can be held liable for failing to control children known to be dangerous.

Most states have statutorily changed the common-law rule, making parents responsible for willful or malicious tortious acts of their children whether or not they are known to be mischief-makers. Thus the Illinois Parental Responsibility Law provides the following: "The parent or legal guardian of an unemancipated minor who resides with such parent or legal guardian is liable for actual damages for the willful or malicious acts of such minor which cause injury to a person or property."Ill. Rev. Stat. (2005), chapter 70, paragraph 51. http://law.justia.com/illinois/codes/2005/chapter57/2045.html. Several other states impose a monetary limit on such liability.

Other Torts Governed by Statute or Regulation

There are certain types of conduct that statutes or regulation attempt to control by placing the burden of liability on those presumably in a position to prevent the unwanted conduct. An example is the "Dramshop Act," which in many states subjects the owner of a bar to liability if the bar continues to serve an intoxicated patron who later is involved in an accident while intoxicated. Another example involves the sale of adulterated or short-weight foodstuffs: the employer of one who sells such may be liable, even if the employer did not know of the sales.

Principal's Criminal Liability

As a general proposition, a principal will not be held liable for an agent's unauthorized criminal acts if the crimes are those requiring specific intent. Thus a department store proprietor who tells his chief buyer to get the "best deal possible" on next fall's fashions is not liable if the buyer steals clothes from the manufacturer. A principal will, however, be liable if the principal directed, approved, or participated in the crime. Cases here involve, for example, a corporate principal's liability for agents' activity in antitrust violations—price-fixing is one such violation.

There is a narrow exception to the broad policy of immunity. Courts have ruled that under certain regulatory statutes and regulations, an agent's criminality may be imputed to the principal, just as civil liability is imputed under Dramshop Acts. These include pure food and drug acts, speeding ordinances, building regulations, child labor rules, and minimum wage and maximum hour legislation. Misdemeanor criminal liability may be imposed upon corporations and individual employees for the sale or shipment of adulterated food in interstate commerce, notwithstanding the fact that the defendant may have had no actual knowledge that the food was adulterated at the time the sale or shipment was made.

Key Takeaway

The principal will be liable for the employee's torts in two circumstances: first, if the principal was directly responsible, as in hiring a person the principal knew or should have known was incompetent or dangerous; second, if the employee committed the tort in the scope of business for the principal. This is the master-servant doctrine or respondeat superior. It imposes vicarious liability on the employer: the master (employer) will be liable if the employee was in the zone of activity creating a risk for the employer ("zone of risk" test), that is—generally—if the employee was where he was supposed to be, when he was supposed to be there, and the incident arose out of the employee's interest (however perverted) in promoting the employer's business.

Special cases of vicarious liability arise in several circumstances. For example, the owner of an automobile may be liable for torts committed by one who borrows it, or if it is—even if indirectly—used for family purposes. Parents are, by statute in many states, liable for their children's torts. Similarly by statute, the sellers and employers of sellers of alcohol or adulterated or short-weight foodstuffs may be liable. The employer of one who commits a crime is not usually liable unless the employer put the employee up to the crime or knew that a crime was being committed. But some prophylactic statutes impose liability on the employer for the employee's crime—even if the employee had no intention to commit it—as a means to force the employer to prevent such actions.

Exercises

1. What is the difference between direct and vicarious employer tort liability?
2. What is meant by the "zone of risk" test?
3. Under what circumstances will an employer be liable for intentional torts of the employee?
4. When will the employer be liable for an employee's criminal acts?

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10.3: Agent's Personal Liability for Torts and Contracts; Termination of Agency

Learning Objectives

By the end of this section, you will be able to:

- Understand the agent's personal liability for tort.
- Understand the agent's personal liability for contract.
- Recognize the ways the agency relationship is terminated.

Agent's Personal Liability for Torts and Contracts

Tort Liability

That a principal is held vicariously liable and must pay damages to an injured third person does not excuse the agent who actually committed the tortious acts. A person is always liable for his or her own torts (unless the person is insane, involuntarily intoxicated, or acting under extreme duress). The agent is personally liable for his wrongful acts and must reimburse the principal for any damages the principal was forced to pay, as long as the principal did not authorize the wrongful conduct. The agent directed to commit a tort remains liable for his own conduct but is not obliged to repay the principal. Liability as an agent can be burdensome, sometimes perhaps more burdensome than as a principal. The latter normally purchases insurance to cover against wrongful acts of agents, but liability insurance policies frequently do not cover the employee's personal liability if the employee is named in a lawsuit individually. Thus doctors' and hospitals' malpractice policies protect a doctor from both her own mistakes and those of nurses and others that the doctor would be responsible for; nurses, however, might need their own coverage. In the absence of insurance, an agent is at serious risk in this lawsuit-conscious age. The risk is not total. The agent is not liable for torts of other agents unless he is personally at fault—for example, by negligently supervising a junior or by giving faulty instructions. For example, an agent, the general manager for a principal, hires Brown as a subordinate. Brown is competent to do the job but by failing to exercise proper control over a machine negligently injures Ted, a visitor to the premises. The principal and Brown are liable to Ted, but the agent is not.

Contract Liability

It makes sense that an agent should be liable for her own torts; it would be a bad social policy indeed if a person could escape tort liability based on her own fault merely because she acted in an agency capacity. It also makes sense that—as is the general rule—an agent is not liable on contracts she makes on the principal's behalf; the agent is not a party to a contract made by the agent on behalf of the principal. No public policy would be served by imposing liability, and in many cases it would not make sense. Suppose an agent contracts to buy $25 million of rolled aluminum for a principal, an airplane manufacturer. The agent personally could not reasonably perform such contract, and it is not intended by the parties that she should be liable. (Although the rule is different in England, where an agent residing outside the country is liable even if it is clear that he is signing in an agency capacity.) But there are three exceptions to this rule: (1) if the agent is undisclosed or partially disclosed, (2) if the agent lacks authority or exceeds it, or (3) if the agent entered into the contract in a personal capacity. We consider each situation.

Agent for Undisclosed or Partially Disclosed Principal

An agent need not, and frequently will not, inform the person with whom he is negotiating that he is acting on behalf of a principal. The secret principal is usually called an "undisclosed principal." Or the agent may tell the other person that he is acting as an agent but not disclose the principal's name, in which event the principal is "partially disclosed." To understand the difficulties that may occur, consider the following hypothetical but common example. A real estate developer known for building amusement parks wants to acquire several parcels of land to construct a new park. He wants to keep his identity secret to hold down the land cost. If the landowners realized that a major building project was about to be launched, their asking price would be quite high. So the developer obtains two options to purchase land by using two secret agents—Betty and Clem.

Betty does not mention to sellers that she is an agent; therefore, to those sellers the developer is an undisclosed principal. Clem tells those with whom he is dealing that he is an agent but refuses to divulge the developer's name or his business interest in the land.

Thus the developer is, to the latter sellers, a partially disclosed principal. Suppose the sellers get wind of the impending construction and want to back out of the deal. Who may enforce the contracts against them?

The developer and the agents may sue to compel transfer of title. The undisclosed or partially disclosed principal may act to enforce his rights unless the contract specifically prohibits it or there is a representation that the signatories are not signing for an undisclosed principal. The agents may also bring suit to enforce the principal's contract rights because, as agents for an undisclosed or partially disclosed principal, they are considered parties to their contracts.

Now suppose the developer attempts to call off the deal. Whom may the sellers sue? Both the developer and the agents are liable. That the sellers had no knowledge of the developer's identity—or even that there was a developer—does not invalidate the contract. If the sellers first sue agent Betty (or Clem), they may still recover the purchase price from the developer as long as they had no knowledge of his identity prior to winning the first lawsuit. The developer is discharged from liability if, knowing his identity, the plaintiffs persist in a suit against the agents and recover a judgment against them anyway. Similarly, if the seller sues the principal and recovers a judgment, the agents are relieved of liability. The seller thus has a "right of election" to sue either the agent or the undisclosed principal, a right that in many states may be exercised any time before the seller collects on the judgment.

Lack of Authority in Agent

An agent who purports to make a contract on behalf of a principal, but who in fact has no authority to do so, is liable to the other party. The theory is that the agent has warranted to the third party that he has the requisite authority. The principal is not liable in the absence of apparent authority or ratification. But the agent does not warrant that the principal has capacity. Thus an agent for a minor is not liable on a contract that the minor later disavows unless the agent expressly warranted that the principal had attained his majority. In short, the implied warranty is that the agent has authority to make a deal, not that the principal will necessarily comply with the contract once the deal is made.

Agent Acting on Own Account

An agent will be liable on contracts made in a personal capacity—for instance, when the agent personally guarantees repayment of a debt. The agent's intention to be personally liable is often difficult to determine on the basis of his signature on a contract. Generally, a person signing a contract can avoid personal liability only by showing that he was in fact signing as an agent. If the contract is signed "Jones, Agent," Jones can introduce evidence to show that there was never an intention to hold him personally liable. But if he signed "Jones" and neither his agency nor the principal's name is included, he will be personally liable. This can be troublesome to agents who routinely indorse checks and notes. There are special rules governing these situations.

Termination of Agency

The agency relationship is not permanent. Either by action of the parties or by law, the relationship will eventually terminate.

By Act of the Parties

Certainly the parties to an agency contract can terminate the agreement. As with the creation of the relationship, the agreement may be terminated either expressly or implicitly.

Express Termination

Many agreements contain specified circumstances whose occurrence signals the end of the agency. The most obvious of these circumstances is the expiration of a fixed period of time ("agency to terminate at the end of three months" or "on midnight, December 31"). An agreement may also terminate on the accomplishment of a specified act ("on the sale of the house") or following a specific event ("at the conclusion of the last horse race").

Mutual consent between the parties will end the agency. Moreover, the principal may revoke the agency or the agent may renounce it; such a revocation or renunciation of agency would be an express termination. Even a contract that states the agreement is irrevocable will not be binding, although it can be the basis for a damage suit against the one who breached the agreement by revoking or renouncing it. As with any contract, a person has the *power* to breach, even in absence of the *right* to do so. If the agency is coupled with an interest, however, so that the authority to act is given to secure an interest that the agent has in the subject matter of the agency, then the principal lacks the power to revoke the agreement.

Implied Termination

There are a number of other circumstances that will spell the end of the relationship by implication. Unspecified events or changes in business conditions or the value of the subject matter of the agency might lead to a reasonable inference that the agency should be terminated or suspended; for example, the principal desires the agent to buy silver but the silver market unexpectedly rises and silver doubles in price overnight. Other circumstances that end the agency include disloyalty of the agent (e.g., he accepts an appointment that is adverse to his first principal or embezzles from the principal), bankruptcy of the agent or of the principal, the outbreak of war (if it is reasonable to infer that the principal, knowing of the war, would not want the agent to continue to exercise authority), and a change in the law that makes a continued carrying out of the task illegal or seriously interferes with it.

By Operation of Law

Aside from the express termination (by agreement of both or upon the insistence of one), or the necessary or reasonable inferences that can be drawn from their agreements, the law voids agencies under certain circumstances. The most frequent termination by operation of law is the death of a principal or an agent. The death of an agent also terminates the authority of subagents he has appointed, unless the principal has expressly consented to the continuing validity of their appointment. Similarly, if the agent or principal loses capacity to enter into an agency relationship, it is suspended or terminated. The agency terminates if its purpose becomes illegal.

Even though authority has terminated, whether by action of the parties or operation of law, the principal may still be subject to liability. Apparent authority in many instances will still exist; this is called lingering authority. It is imperative for a principal on termination of authority to notify all those who may still be in a position to deal with the agent. The only exceptions to this requirement are when termination is effected by death, loss of the principal's capacity, or an event that would make it impossible to carry out the object of the agency.

Key Takeaway

A person is always liable for her own torts, so an agent who commits a tort is liable; if the tort was in the scope of employment the principal is liable too. Unless the principal put the agent up to committing the tort, the agent will have to reimburse the principal. An agent is not generally liable for contracts made; the principal is liable. But the agent will be liable if he is undisclosed or partially disclosed, if the agent lacks authority or exceeds it, or, of course, if the agent entered into the contract in a personal capacity.

Agencies terminate expressly or impliedly or by operation of law. An agency terminates expressly by the terms of the agreement or mutual consent, or by the principal's revocation or the agent's renunciation. An agency terminates impliedly by any number of circumstances in which it is reasonable to assume one or both of the parties would not want the relationship to continue. An agency will terminate by operation of law when one or the other party dies or becomes incompetent, or if the object of the agency becomes illegal. However, an agent may have apparent lingering authority, so the principal, upon termination of the agency, should notify those who might deal with the agent that the relationship is severed.

Exercises

1. Pauline, the owner of a large bakery business, wishes to expand her facilities by purchasing the adjacent property. She engages Alice as an agent to negotiate the deal with the property owner but instructs her not to tell the property owner that she—Alice—is acting as an agent because Pauline is concerned that the property owner would demand a high price. A reasonable contract is made. When the economy sours, Pauline decides not to expand and cancels the plan. Who is liable for the breach?
2. Peter, the principal, instructs his agent, Alice, to tour England and purchase antique dining room furniture for Peter's store. Alice buys an antique bed set. Who is liable, Peter or Alice? Suppose the seller did not know of the limit on Alice's authority and sells the bed set to Alice in good faith. What happens when Peter discovers he owes the seller for the set?
3. Under what circumstances will the agency terminate expressly?
4. Agent is hired by Principal to sell a new drug, Phobbot. Six months later, as it becomes apparent that Phobbot has nasty side effects (including death), the Food and Drug Administration orders the drug pulled from the shelves. Agent's agency is terminated; what terminology is appropriate to describe how?
5. Principal engages Agent to buy lumber, and in that capacity Agent deals with several large timber owners. Agent's contract ends on July 31; on August 1, Agent buys $150,000 worth of lumber from a seller with whom he had dealt previously on Principal's

behalf. Who is liable and why?

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10.4: Cases

Implied Authority

Kanavos v. Hancock Bank & Trust Company

439 N.E.2d 311 (Mass. 1982)

KASS, J.

At the close of the plaintiff's evidence, the defendant moved for a directed verdict, which the trial judge allowed. The judge's reason for so doing was that the plaintiff, in his contract action, failed to introduce sufficient evidence tending to prove that the bank officer who made the agreement with which the plaintiff sought to charge the bank had any authority to make it. Upon review of the record we are of opinion that there was evidence which, if believed, warranted a finding that the bank officer had the requisite authority or that the bank officer had apparent authority to make the agreement in controversy. We therefore reverse the judgment.

For approximately ten years prior to 1975, Harold Kanavos and his brother borrowed money on at least twenty occasions from the Hancock Bank & Trust Company (the Bank), and, during that period, the loan officer with whom Kanavos always dealt was James M. Brown. The aggregate loans made by the Bank to Kanavos at any given time went as high as $800,000.

Over that same decade, Brown's responsibilities at the Bank grew, and he had become executive vice-president. Brown was also the chief loan officer for the Bank, which had fourteen or fifteen branches in addition to its head office. Physically, Brown's office was at the head office, toward the rear of the main banking floor, opposite the office of the president—whose name was Kelley. Often Brown would tell Kanavos that he had to check an aspect of a loan transaction with Kelley, but Kelley always backed Brown up on those occasions.…

[The plaintiff, Harold Kanavos, entered into an agreement with the defendant Bank whereby stock owned by the Kanavos brothers was sold to the Bank and the plaintiff was given an option to repurchase the stock. Kanavos' suit against the Bank was based on an amendment to the agreement offered by Brown.]

Kanavos was never permitted to introduce in evidence the terms of the offer Brown made. That offer was contained in a writing, dated July 16, 1976, on bank letterhead, which read as follows: "This letter is to confirm our conversation regarding your option to re-purchase the subject property. In lieu of your not exercising your option, we agree to pay you $40,000 representing a commission upon our sale of the subject property, and in addition, will give you the option to match the price of sale of said property to extend for a 60 day period from the time our offer is received." Brown signed the letter as executive vice-president. The basis of exclusion was that the plaintiff had not established the authority of Brown to make with Kanavos the arrangement memorialized in the July 16, 1976, letter.

Whether Brown's job description impliedly authorized the right of last refusal or cash payment modification is a question of how, in the circumstances, a person in Brown's position could reasonably interpret his authority. Whether Brown had apparent authority to make the July 16, 1976, modification is a question of how, in the circumstances, a third person, e.g., a customer of the Bank such as Kanavos, would reasonably interpret Brown's authority in light of the manifestations of his principal, the Bank.

Titles of office generally do not establish apparent authority. Brown's status as executive vice-president was not, therefore, a badge of apparent authority to modify agreements to which the Bank was a party.

Trappings of office, e.g., office and furnishing, private secretary, while they may have some tendency to suggest executive responsibility, do not without other evidence provide a basis for finding apparent authority. Apparent authority is drawn from a variety of circumstances. Thus in *Federal Nat. Bank v. O'Connell*…(1940), it was held apparent authority could be found because an officer who was a director, vice-president and treasurer took an active part in directing the affairs of the bank in question and was seen by third parties talking with customers and negotiating with them. In *Costonis v. Medford Housing Authy*.…(1961), the executive director of a public housing authority was held to have apparent authority to vary specifications on the basis of the cumulative effect of what he had done and what the authority appeared to permit him to do.

In the instant case there was evidence of the following variety of circumstances: Brown's title of executive vice-president; the location of his office opposite the president; his frequent communications with the president; the long course of dealing and

negotiations; the encouragement of Kanavos by the president to deal with Brown; the earlier amendment of the agreement by Brown on behalf of the Bank on material points, namely the price to be paid by the Bank for the shares and the repurchase price; the size of the Bank (fourteen or fifteen branches in addition to the main office); the secondary, rather than fundamental, nature of the change in the terms of the agreement now repudiated by the Bank, measured against the context of the overall transaction; and Brown's broad operating authority…all these added together would support a finding of apparent authority. When a corporate officer, as here, is allowed to exercise general executive responsibilities, the "public expectation is that the corporation should be bound to engagements made on its behalf by those who presume to have, and convincingly appear to have, the power to agree." [Citation] This principle does not apply, of course, where in the business context, the requirement of specific authority is presumed, e.g., the sale of a major asset by a corporation or a transaction which by its nature commits the corporation to an obligation outside the scope of its usual activity. The modification agreement signed by Brown and dated July 16, 1976, should have been admitted in evidence, and a verdict should not have been directed.

Judgment reversed.

? Case Questions

1. Why are "titles of office" insufficient to establish apparent authority?
2. Why are "trappings of office" insufficient to establish apparent authority?
3. What is the relationship between apparent authority and estoppel? Who is estopped to do what, and why?

Employer's Liability for Employee's Intentional Torts: Scope of Employment

Lyon v. Carey

533 F.2d 649 (Cir. Ct. App. DC 1976)

McMillan, J.:

Corene Antoinette Lyon, plaintiff, recovered a $33,000.00 verdict [about $142,000 in 2010 dollars] in the United States District Court for the District of Columbia before Judge Barrington T. Parker and a jury, against the corporate defendants, George's Radio and Television Company, Inc., and Pep Line Trucking Company, Inc. The suit for damages arose out of an assault, including rape, committed with a knife and other weapons upon the plaintiff on May 9, 1972, by Michael Carey, a nineteen-year-old deliveryman for Pep Line Trucking Company, Inc. Three months after the trial, Judge Parker set aside the verdict and rendered judgment for both defendants notwithstanding the verdict. Plaintiff appealed.…

Although the assault was perhaps at the outer bounds of respondeat superior, the case was properly one for the jury. Whether the assault in this case was the outgrowth of a job-related controversy or simply a personal adventure of the deliveryman, was a question for the jury. This was the import of the trial judge's instructions. The verdict as to Pep Line should not have been disturbed.

Irene Lyon bought a mattress and springs for her bed from the defendant George's Radio and Television Company, Inc. The merchandise was to be delivered on May 9, 1972. Irene Lyon had to be at work and the plaintiff [Irene's sister] Corene Lyon, had agreed to wait in her sister's apartment to receive the delivery.

A C.O.D. balance of $13.24 was due on the merchandise, and Irene Lyon had left a check for $13.24 to cover that balance. Plaintiff had been requested by her sister to "wait until the mattress and the springs came and to check and make sure they were okay."

Plaintiff, fully clothed, answered the door. Her description of what happened is sufficiently brief and unqualified that it will bear repeating in full. She testified, without objection, as follows:

I went to the door, and I looked in the peephole, and I asked who was there. The young man told me he was a delivery man from George's. He showed me a receipt, and it said, 'George's.' He said he [needed cash on delivery—COD], so I let him in, and I told him to bring the mattress upstairs and he said, 'No,' that he wasn't going to lug them upstairs, and he wanted the COD first, and I told him I wanted to see the mattress and box springs to make sure they were okay, and he said no, he wasn't going to lug them upstairs [until he got the check].

So this went back and forwards and so he was getting angry, and I told him to wait right here while I go get the COD. I went to the bedroom to get the check, and I picked it up, and I turned around and he was right there.

And then I was giving him the check and then he told me that his boss told him not to accept a check, that he wanted cash money, and that if I didn't give him cash money, he was going to take it on my ass, and he told me that he was no delivery man, he was a rapist and then he threw me on the bed.

[The Court] Talk louder, young lady, the jury can't hear you.

[The witness] And then he threw me on the bed, and he had a knife to my throat.

[Plaintiff's attorney] Then what happened?

And then he raped me.

Plaintiff's pre-trial deposition was a part of the record on appeal, and it shows that Carey raped plaintiff at knife point; that then he chased her all over the apartment with a knife and scissors and cut plaintiff in numerous places on her face and body, beat and otherwise attacked her. All of the physical injury other than the rape occurred after rather than before the rape had been accomplished.…

[Carey was convicted of rape and sent to prison. The court determined that George's was properly dismissed because Pep Line, Carey's employer, was an independent contractor over which George's had no control.]

The principal question, therefore, is whether the evidence discloses any other basis upon which a jury could reasonably find Pep Line, the employer of Carey, liable for the assault.

Michael Carey was in the employment of the defendant Pep Line as a deliveryman. He was authorized to make the delivery of the mattress and springs plaintiff's sister had bought. He gained access to the apartment only upon a showing of the delivery receipt for the merchandise. His employment contemplated that he visit and enter that particular apartment. Though the apartment was not owned by nor in the control of his employer, it was nevertheless a place he was expected by his employer to enter.

After Carey entered, under the credentials of his employment and the delivery receipt, a dispute arose naturally and immediately between him and the plaintiff about two items of great significance in connection with his job. These items were the request of the plaintiff, the customer's agent, to inspect the mattress and springs before payment (which would require their being brought upstairs before the payment was made), and Carey's insistence on getting cash rather than a check.

The dispute arose out of the very transaction which had brought Carey to the premises, and, according to the plaintiff's evidence, out of the employer's instructions to get cash only before delivery.

On the face of things, Pep Line Trucking Company, Inc. is liable, under two previous decisions of the Court of Appeals for the District of Columbia Circuit. [Citation (1953)] held a taxi owner liable for damages (including a broken leg) sustained by a customer who had been run over by the taxi in pursuit of a dispute between the driver and the customer about a fare. [Citation (1939)], held a restaurant owner liable to a restaurant patron who was beaten with a stick by a restaurant employee, after a disagreement over the service. The theory was that:

It is well established that an employer may be held responsible in tort for assaults committed by an employee while he is acting within the scope of his employment, even though he may act wantonly and contrary to his employer's instructions. [Citations] "… having placed [the employee] in charge and committed the management of the business to his care, defendants may not escape liability either on the ground of his infirmity of temperament or because, under the influence of passion aroused by plaintiff's threat to report the circumstances, he went beyond the ordinary line of duty and inflicted the injury shown in this case. [Citations]"

Munick v. City of Durham ([Citation], Supreme Court of North Carolina, 1921), though not a binding precedent, is informative and does show that the theory of liability advanced by the plaintiff is by no means recent in origin. The plaintiff, Munick, a Russian born Jew, testified that he went to the Durham, North Carolina city water company office on April 17, 1919, and offered to pay his bill with "three paper dollars, one silver dollar, and fifty cents in pennies." The pennies were in a roll "like the bank fixes them." The clerk gave a receipt and the plaintiff prepared to leave the office. The office manager came into the room, saw the clerk counting the pennies, became enraged at the situation, shoved the pennies onto the floor and ordered Munick to pick them up. Bolton, the manager, "locked the front door and took me by the jacket and called me 'God damned Jew,' and said, 'I want only bills.' I did not say anything and he hit me in the face. I did not resist, and the door was locked and I could not get out.…" With the

door locked, Bolton then repeatedly choked and beat the plaintiff, finally extracted a bill in place of the pennies, and ordered him off the premises with injuries including finger marks on his neck that could be seen for eight or ten days. Bolton was convicted of unlawful assault [but the case against the water company was dismissed].

The North Carolina Supreme Court (Clark, C. J.) reversed the trial court's dismissal and held that the case should have gone to the jury. The court…said [Citation]:

"'It is now fully established that corporations may be held liable for negligent and malicious torts, and that responsibility will be imputed whenever such wrongs are committed by their employees and agents in the course of their employment and within its scope * * * in many of the cases, and in reliable textbooks * * * 'course of employment' is stated and considered as sufficiently inclusive; but, whether the one or the other descriptive term is used, they have the same significance in importing liability on the part of the principal when the agent is engaged in the work that its principal has employed or directed him to do and * * * in the effort to accomplish it. When such conduct comes within the description that constitutes an actionable wrong, the corporation principal, as in other cases of principal and agent, is liable not only for 'the act itself, but for the ways and means employed in the performance thereof.'

"In 1 Thompson, Negligence, s 554, it is pointed out that, unless the above principle is maintained:

"'It will always be more safe and profitable for a man to conduct his business vicariously than in his own person. He would escape liability for the consequences of many acts connected with his business, springing from the imperfections of human nature, because done by another, for which he would be responsible if done by himself. Meanwhile, the public, obliged to deal or come in contact with his agent, for injuries done by them must be left wholly without redress. He might delegate to persons pecuniarily irresponsible the care of large factories, of extensive mines, of ships at sea, or of railroad trains on land, and these persons, by the use of the extensive power thus committed to them, might inflict wanton and malicious injuries on third persons, without other restraint than that which springs from the imperfect execution of the criminal laws. A doctrine so fruitful of mischief could not long stand unshaken in an enlightened jurisprudence.' This court has often held the master liable, even if the agent was willful, provided it was committed in the course of his employment. [Citation]"

"The act of a servant done to effect some independent purpose of his own and not with reference to the service in which he is employed, or while he is acting as his own master for the time being, is not within the scope of his employment so as to render the master liable therefor. In these circumstances the servant alone is liable for the injury inflicted." [Citation].…"The general idea is that the employee at the time of doing the wrongful act, in order to fix liability on the employer, must have been acting in behalf of the latter and not on his own account [Citation]."

The principal physical (as opposed to psychic) damage to the plaintiff is a number of disfiguring knife wounds on her head, face, arms, breasts and body. If the instrumentalities of assault had not included rape, the case would provoke no particular curiosity nor interest because it comes within all the classic requirements for recovery against the master. The verdict is not attacked as excessive, and could not be excessive in light of the physical injuries inflicted.

It may be suggested that [some of the cases discussed] are distinguishable because in each of those cases the plaintiff was a business visitor on the defendant's "premises."…Home delivery customers are usually in their homes, sometimes alone; and deliveries of merchandise may expose householders to one-on-one confrontations with deliverymen. It would be a strange rule indeed which, while allowing recovery for assaults committed in "the store," would deny a master's liability for an assault committed on a lone woman in her own home, by a deliveryman required by his job to enter the home.…

If, as in [one case discussed], the assault was not motivated or triggered off by anything in the employment activity but was the result of only propinquity and lust, there should be no liability. However, if the assault, sexual or otherwise, was triggered off or motivated or occasioned by a dispute over the conduct then and there of the employer's business, then the employer should be liable.

It is, then, a question of fact for the trier of fact, rather than a question of law for the court, whether the assault stemmed from purely and solely personal sources or arose out of the conduct of the employer's business; and the trial judge so instructed the jury.

It follows that, under existing decisions of the District of Columbia Circuit, plaintiff has made out a case for the jury against Pep Line Trucking, Inc. unless the sexual character of one phase of the assault bars her from recovery for damages from all phases of the assault.

We face, then, this question: Should the entire case be taken from the jury because, instead of a rod of wood (as in [one case]), in addition to weapons of steel (as in [one case, a knife]); and in addition to his hands (as in [the third case, regarding the dispute about the pennies]), Carey also employed a sexual weapon, a rod of flesh and blood in the pursuit of a job-related controversy?

The answer is, No. It is a jury's job to decide how much of plaintiff's story to believe, and how much if any of the damages were caused by actions, including sexual assault, which stemmed from job-related sources rather than from purely personal origins.…

The judgment is affirmed as to the defendant George's and reversed as to the defendant Pep Line Trucking Company, Inc.

? Case Questions

1. What triggered the dispute here?
2. The court observes, "On the face of things, Pep Line Trucking Company, Inc. is liable." But there are two issues that give the court cause for more explanation. (1) Why does the court discuss the point that the assault did not occur on the employer's premises? (2) Why does the court mention that the knife assault happened *after* the rape?
3. It is difficult to imagine that a sexual assault could be anything other than some "purely and solely personal" gratification, unrelated to the employer's business. How did the court address this?
4. What is the controlling rule of law as to the employer's liability for intentional torts here?
5. What does the court mean when it says, "the assault was perhaps at the outer bounds of respondeat superior"?
6. Would the jury think about who had the "deep pocket" here? Who did have it?

Employer's Liability for Employee's Intentional Torts: Scope of Employment

Cockrell v. Pearl River Valley Water Supply Dist.

865 So.2d 357 (Miss. 2004)

The Pearl River Valley Water Supply District ("District") was granted summary judgment pursuant to the Mississippi Tort Claims Act (MTCA) dismissing with prejudice all claims asserted against it by Sandra Cockrell. Cockrell appeals the ruling of the circuit court citing numerous errors. Finding the motion for summary judgment was properly granted in favor of the District, this Court affirms the final judgment entered by the Circuit Court of Rankin County.

Facts and Proceedings in the Trial Court

On June 28, 1998, Sandra Cockrell was arrested for suspicion of driving under the influence of alcohol by Officer Joey James who was employed as a security patrol officer with the Reservoir Patrol of the Pearl River Valley Water Supply District. Officer James then transported Cockrell to the Reservoir Patrol office and administered an intoxilyzer test. The results of the test are not before us; however, we do know that after the test was administered, Officer James apologized to Cockrell for arresting her, and he assured her that he would prepare her paperwork so that she would not have to spend much time in jail. As they were leaving the Reservoir Patrol office, Officer James began asking Cockrell personal questions such as where she lived, whether she was dating anyone and if she had a boyfriend. Officer James then asked Cockrell for her cell phone number so that he could call and check on her. As they were approaching his patrol car for the trip to the Rankin County jail, Officer James informed Cockrell that she should be wearing handcuffs; however, he did not handcuff Cockrell, and he allowed her to ride in the front seat of the patrol car with him. In route to the jail, Cockrell became emotional and started crying. As she was fixing her makeup using the mirror on the sun visor, Officer James pulled his patrol car into a church parking lot and parked the car. He then pulled Cockrell towards him in an embrace and began stroking her back and hair telling her that things would be fine. Cockrell told Officer James to release her, but he continued to embrace her for approximately five minutes before continuing on to the jail.

On June 30, 1998, Cockrell returned to the Reservoir Patrol office to retrieve her driver's license. Officer James called Cockrell into his office and discussed her DUI charge with her. As she was leaving, Officer James grabbed her from behind, turned her around, pinned both of her arms behind her and pulled her to his chest. When Officer James bent down to kiss her, she ducked her head, thus causing Officer James to instead kiss her forehead. When Officer James finally released Cockrell, she ran out of the door and drove away. [Subsequently, Cockrell's attorney threatened civil suit against Patrol; James was fired in October 1998.]

On September 22, 1999, Cockrell filed a complaint for damages against the District alleging that on the nights of June 28 and June 30, 1998, Officer James was acting within the course and scope of his employment with the District and that he acted with reckless

disregard for her emotional well-being and safety.…On April 2, 2002, the District filed its motion for summary judgment alleging that there was no genuine issue of material fact regarding Cockrell's claim of liability. The motion alleged that the conduct described by Cockrell was outside the course and scope of Officer James's public employment as he was intending to satisfy his lustful urges. Cockrell responded to the motion arguing that the misconduct did occur in the course and scope of Officer James's employment with the District and also that the misconduct did not reach the level of a criminal offense such that the District could be found not liable under the MTCA.

The trial court entered a final judgment granting the District's motion for summary judgment and dismissing the complaint with prejudice. The trial court found that the District could not be held liable under the MTCA for the conduct of Officer James which was both criminal and outside the course and scope of his employment. Cockrell…appeal[ed].

Discussion

Summary judgment is granted in cases where there is "no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law."…

Cockrell contends there is a genuine issue of material of fact regarding whether Officer James was acting in the course and scope of his employment with the District during the incidents which occurred on the nights of June 28 and June 30, 1998. Cockrell argues Officer James's conduct, although inappropriate, did not rise to the level of criminal conduct. Cockrell contends Officer James's action of hugging Cockrell was similar to an officer consoling a victim of a crime. Cockrell does admit that Officer James's action of kissing her is more difficult to view as within the course and scope of his employment…

The District argues that although Officer James acted within the course and scope of his duties when he arrested Cockrell, his later conduct, which was intended to satisfy his lustful desires, was outside the scope of his employment with it.…

"Mississippi law provides that an activity must be in furtherance of the employer's business to be within the scope and course of employment." [Citation] To be within the course and scope of employment, an activity must carry out the employer's purpose of the employment or be in furtherance of the employer's business. [Citations] Therefore, if an employee steps outside his employer's business for some reason which is not related to his employment, the relationship between the employee and the employer "is temporarily suspended and this is so 'no matter how short the time and the [employer] is not liable for [the employee's] acts during such time.'" "An employee's personal unsanctioned recreational endeavors are beyond the course and scope of his employment." [Citation]

[In one case cited,] Officer Kerry Collins, a Jackson Police officer, was on duty when he came upon the parked car of L.T., a minor, and her boyfriend, who were about to engage in sexual activity. [Citation] Officer Collins instructed L.T. to take her boyfriend home, and he would follow her to make sure she followed his orders. After L.T. dropped off her boyfriend, Officer Collins continued to follow her until he pulled L.T. over. Officer Collins then instructed L.T. to follow him to his apartment or else he would inform L.T.'s parents of her activities. L.T. followed Officer Collins to his apartment where they engaged in sexual activity. Upon returning home, L.T. told her parents everything that had happened. L.T. and her parents filed suit against Officer Collins, the City of Jackson and the Westwood Apartments, where Officer Collins lived rent free in return for his services as a security guard.… The district court granted summary judgment in favor of the City finding that Officer Collins acted outside the course and scope of his employment with the Jackson Police Department. [Citation]

In [Citation] the plaintiff sued the Archdiocese of New Orleans for damages that allegedly resulted from his sexual molestation by a Catholic priest. The Fifth Circuit found that the priest was not acting within the course and scope of his employment. The Fifth Circuit held that "smoking marijuana and engaging in sexual acts with minor boys" in no way furthered the interests of his employer.

The Southern District of Mississippi and the Fifth Circuit, applying Mississippi law, have held that sexual misconduct falls outside the course and scope of employment. There is no question that Officer James was within the course and scope of his employment when he first stopped Cockrell for suspicion of driving under the influence of alcohol. However, when Officer James diverted from his employment for personal reasons, he was no longer acting in the furtherance of his employer's interests…Therefore, the District cannot be held liable…for the misconduct of Officer James which occurred outside the course and scope of his employment.

Affirmed.

Case Questions

1. How can this case and *Lyon v. Carey* (Section 15.4.2 “Employer’s Liability for Employee’s Intentional Torts: Scope of Employment”) be reconciled? Both involve an agent’s unacceptable behavior—assault—but in *Lyon* the agent’s actions were imputed to the principal, and in *Cockrell* the agent’s actions were not imputed to the principal.
2. What is the controlling rule of law governing the principal’s liability for the agent’s actions?
3. The law governing the liability of principals for acts of their agents is well settled. Thus the cases turn on the facts. Who decides what the facts are in a lawsuit?

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10.5: Summary and Exercises

Summary

A contract made by an agent on behalf of the principal legally binds the principal. Three types of authority may bind the principal: (1) express authority—that which is actually given and spelled out, (2) implied authority—that which may fairly be inferred from the parties' relationship and which is incidental to the agent's express authority, and (3) apparent authority—that which reasonably appears to a third party under the circumstances to have been given by the principal. Even in the absence of authority, a principal may ratify the agent's acts.

The principal may be liable for tortious acts of the agent but except under certain regulatory statutes may not be held criminally liable for criminal acts of agents not prompted by the principal. Under the doctrine of respondeat superior, a principal is generally liable for acts by a servant within the scope of employment. A principal usually will not be held liable for acts of nonservant agents that cause physical damage, although he will be held liable for nonphysical torts, such as misrepresentation. The principal will not be held liable for tortious acts of independent contractors, although the principal may be liable for injuries resulting from his failure to act in situations in which he was not legally permitted to delegate a duty to act. Whenever an agent is acting to further the principal's business interests, the principal will be held vicariously liable for the agent's intentional torts. What constitutes scope of employment is not easy to determine; the modern trend is to hold a principal liable for the conduct of an agent if it was foreseeable that the agent might act as he did.

Most states have special rules of vicarious liability for special situations; for example, liability of an automobile owner for use by another. Spouses are not vicariously liable for each other, nor are parents for children, except for failing to control children known to be dangerous.

In general, an agent is not personally liable on contracts he has signed on behalf of a principal. This general rule has several exceptions recognized in most states: (1) when the agent is serving an undisclosed or partially disclosed principal, (2) when the agent lacks authority or exceeds his authority, and (3) if the agent entered into the contract in a personal capacity.

The agency relationship may be terminated by mutual consent, by express agreement of the parties that the agency will end at a certain time or on the occurrence of a certain event, or by an implied agreement arising out of the circumstances in each case. The agency may also be unilaterally revoked by the principal—unless the agency is coupled with an interest—or renounced by the agent. Finally, the agency will terminate by operation of law under certain circumstances, such as death of the principal or agent.

Exercises

1. Parke-Bernet Galleries, acting as agent for an undisclosed principal, sold a painting to Weisz. Weisz later discovered that the painting was a forgery and sued Parke-Bernet for breach of contract. In defense, Parke-Bernet argued that as a general rule, agents are not liable on contracts made for principals. Is this a good defense? Explain.
2. Lynch was the loan officer at First Bank. Patterson applied to borrow $25,000. Bank policy required that Lynch obtain a loan guaranty from Patterson's employer, a milk company. The manager of the milk company visited the bank and signed a guaranty on behalf of the company. The last paragraph of the guaranty stated, "This guaranty is signed by an officer having legal right to bind the company through authorization of the Board of Directors." Should Lynch be satisfied with this guaranty? Would he be satisfied if the president of the milk company, who was also a director, affirmed that the manager had authority to sign the guaranty? Explain.
3. Ralph owned a retail meat market. Ralph's agent Sam, without authority but purporting to act on Ralph's behalf, borrowed $7,500 from Ted. Although he never received the money, Ralph repaid $700 of the alleged loan and promised to repay the rest. If Sam had no authority to make the loan, is Ralph liable? Why?
4. A guest arrived early one morning at the Hotel Ohio. Clemens, a person in the hotel office who appeared to be in charge, walked behind the counter, registered the guest, gave him a key, and took him to his room. The guest also checked valuables (a diamond pin and money) with Clemens, who signed a receipt on behalf of the hotel. Clemens in fact was a roomer at the hotel, not an employee, and had no authority to act on behalf of the hotel. When Clemens absconded with the valuables, the guest sued the hotel. Is the hotel liable? Why?
5. A professional basketball player punched an opposing player in the face during the course of a game. The opponent, who was seriously injured, sued the owner of the team for damages. A jury awarded the player $222,000 [about $800,000 in 2010

dollars] for medical expenses, $200,000 [$700,000] for physical pain, $275,000 [$963,000] for mental anguish, $1,000,000 [$3.5 million] for lost earnings, and $1,500,000 [$5.2 million] in punitive damages (which was $500,000 more than requested by the player). The jury also awarded $50,000 [$150,000] to the player's wife for loss of companionship. If we assume that the player who threw the punch acted out of personal anger and had no intention to further the business, how could the damage award against his principal be legally justified?

6. A doctor in a University of Chicago hospital seriously assaulted a patient in an examining room. The patient sued the hospital on the theory that the doctor was an agent or employee of the hospital and the assault occurred within the hospital. Is the hospital liable for the acts of its agent? Why?
7. Hector was employed by a machine shop. One day he made a delivery for his employer and proceeded back to the shop. When he was four miles from the shop and on the road where it was located, he turned left onto another road to visit a friend. The friend lived five miles off the turnoff. On the way to the friend's house, Hector caused an accident. The injured person sued Hector's employer. Is the employer liable? Discuss.
8. A fourteen-year-old boy, who had no driver's license, took his parents' car without permission and caused an automobile accident. A person injured in the accident sued the boy's parents under the relevant state's Parental Responsibility Law (mentioned in Section 15.2.1 "Principal's Tort Liability"). Are the parents liable? Discuss.
9. In the past decades the Catholic Church has paid out hundreds of millions of dollars in damage awards to people—mostly men—who claimed that when they were boys and teenagers they were sexually abused by their local parish priests, often on Church premises. That is, the men claimed they had been victims of child rape. Obviously, such behavior is antithetical to any reasonable standard of clergy behavior: the priests could not have been in the scope of employment. How is the Church liable?

SELF CHECK QUESTIONS

1. Authority that legally may bind the principal includes
    1. implied authority
    2. express authority
    3. apparent authority
    4. all of the above
2. As a general rule, a principal is not
    1. liable for tortious acts of an agent, even when the principal is negligent
    2. liable for acts of a servant within the scope of employment
    3. criminally liable for acts of the agent
    4. liable for nondelegable duties performed by independent contractors
3. An agent may be held personally liable on contracts signed on behalf of a principal when
    1. the agent is serving an undisclosed or partially disclosed principal
    2. the agent exceeds his authority
    3. the agent entered into the contract in a personal capacity
    4. all of the above are true
4. An agency relationship may be terminated by
    1. an implied agreement arising out of the circumstances
    2. mutual consent of parties
    3. death of the principal or agent
    4. all of the above
5. The principal's liability for the agent's acts of which the principal had no knowledge or intention to commit is called
    1. contract liability
    2. implied liability
    3. respondeat superior
    4. all of the above

AnswerS

1. d
2. c
3. d
4. c
5. b

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CHAPTER OVERVIEW

11: Forms of Business Ownership

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11.1: Introduction



Exhibit 4.1: (Credit: pxhere / Attribution CC0 Public Domain)

EXPLORING BUSINESS CAREERS

Jessica MacLean

Sole Proprietor In most any elementary school classroom, at least one child's answer to the question, "What do you want to do with your life?" will be, "A lawyer." One of the most popular careers, lawyers are powerful figures in society, shaping our laws and ensuring that we adhere to them. Their prominence and power have led to the stereotype of rich, career-driven lawyers, often leaving no room in our minds for those who truly want to bring justice to the world. However, Jessica MacLean, a lawyer focusing primarily on women's rights, is quick to say that, as with many stereotypes, that is only one side of the story. "I know because I lived that—I was on my way to being a successful corporate lawyer. But I realized what I was doing and how different that was from why I'd started practicing. So I walked away from it all to start my own practice."

Nervous about the prospect of private practice, she has chosen to operate as a sole proprietorship for now. Sole proprietorships are easy to set up for people who want to work on their own, prefer direct control of the business, and desire the flexibility to sell the business or close the doors at any time. "For me, it's the best choice because I am not responsible for or to anyone else. I can easily dissolve the business if I find it is not proceeding how I'd planned. More positively, too, if it does succeed, I know that success is due to my hard work.

Indeed MacLean's law career was not always in corporate law. She turned her sights toward law after a gender and communications professor at DePaul University suggested her argumentative style might be an asset in that profession. "She said I needed to tone it down for class—that the other students seemed afraid to speak up—but then asked if I'd ever considered being a lawyer." MacLean, who had always been interested in issues of justice and legality surrounding women, took her professor's advice and made the leap into law.

While in law school, she clerked for the city of Chicago in their department of personnel's sexual harassment office and volunteered for the Cook County state's attorney's office in the domestic violence division. The cases she worked on were emotionally trying. Despite the difficulty of the cases, she was drawn to them, compelled by the people she helped and the change she was able to effect. After school, she continued in related practice, working first for the Cook County state's attorney's office.

After several years with the state's attorney's office, she needed a change. It was then that MacLean decided to work for a corporation, a form of business that you will learn about in this chapter. "Why did I switch to corporate law? I think I was burnt out, to some extent. It's so hard to work on those cases, day after day. I needed to see if I would be better somewhere else."

Having enjoyed the rewards of working with the state's attorney's office and a corporation and being a sole proprietor, in 2014 MacLean joined a limited liability partnership (LLP, a form of business that you will learn about in this chapter) firm in Chicago. As her needs changed, the form and type of business organization she has worked for has changed also.

This chapter discusses sole proprietorships, as well as several other forms of business ownership, including partnerships and corporations, and compares the advantages and disadvantages of each.

With a good idea and some cash in hand, you decide to start a business. But before you get going, you need to ask yourself some questions that will help you decide what form of business organization will best suit your needs.

Would you prefer to go it alone as a *sole proprietorship*, or do you want others to share your burdens and challenges in a *partnership*? Or would the limited liability protection of a *corporation*, or perhaps the flexibility of a *limited liability company (LLC)*, make more sense?

There are other questions you need to consider too: Will you need financing? How easy will it be to obtain? Will you attract employees? How will the business be taxed, and who will be liable for the company's debts? If you choose to share ownership with others, how much operating control would they want, and what costs would be associated with that?

As **Table 4.1** illustrates, sole proprietorships are the most popular form of business ownership, accounting for 72 percent of all businesses, compared with 10 percent for partnerships and 18 percent for corporations. Because most sole proprietorships and partnerships remain small, corporations generate approximately 81 percent of total business revenues and 58 percent of total profits.

Most start-up businesses select one of these major ownership forms. In the following pages, we will discover the advantages and disadvantages of each form of business ownership and the factors that may make it necessary to change from one form of organization to another as the needs of the business change. As a company expands from small to midsize or larger, the form of business structure selected in the beginning may no longer be appropriate.

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11.2: Going It Alone- Sole Proprietorships

What are the advantages and disadvantages of the sole proprietorship form of business organization?

Jeremy Shepherd was working full-time for an airline when, at the age of 22, he wandered into an exotic pearl market in China, searching for a gift for his girlfriend. The strand of pearls he handpicked by instinct was later valued by a jeweler back in the States at 20 times what he paid for it. Jeremy cashed his next paycheck and hurried back to Asia, buying every pearl he could afford. Founded in 1996, his company Pearl Paradise was brought online in 2000. Shepherd chose the **sole proprietorship** form of business organization—a business that is established, owned, operated, and often financed by one person—because it was the easiest to set up. He did not want partners, and low liability exposure made incorporating unnecessary.

Fluent in Mandarin Chinese, Japanese, and Spanish and immersed in Asian culture, Shepherd believed the internet was the way to market his pearls (**http://www.pearlparadise.com**). Offering a wide range of pearl jewelry through 14 websites worldwide, his company sells as many as 1,000 items per day. The recent addition of an exclusive Los Angeles showroom allows celebrity customers to shop by appointment. With $20 million in sales annually, PearlParadise.com is the industry leader in terms of sales and volume.[1]

Table 4.1: Comparison of Forms of Business Organization

Form	Number	Sales	Profits
Sole Proprietorships	72 percent	4 percent	15 percent
Partnerships	10 percent	15 percent	27 percent
Corporations	18 percent	81 percent	58 percent

Source: Internal Revenue Service, as reported in Table 746, U.S. Bureau of the Census, *Statistical Abstract of the United States, 2012*, 131st ed. (Washington, DC: U.S. Government Printing Office, 2012), p. 492. Note: US Bureau of Census stopped collecting and publishing this data after 2012.

Advantages of Sole Proprietorships

Sole proprietorships have several advantages that make them popular:

- *Easy and inexpensive to form*. As Jeremy Shepherd discovered, sole proprietorships have few legal requirements (local licenses and permits) and are not expensive to form, making them the business organization of choice for many small companies and start-ups.
- *Profits all go to the owner*. The owner of a sole proprietorship obtains the start-up funds and gets all the profits earned by the business. The more efficiently the firm operates, the higher the company's profitability.
- *Direct control of the business*. All business decisions are made by the sole proprietorship owner without having to consult anyone else.
- *Freedom from government regulation*. Sole proprietorships have more freedom than other forms of business with respect to government controls.
- *No special taxation*. Sole proprietorships do not pay special franchise or corporate taxes. Profits are taxed as personal income as reported on the owner's individual tax return.
- *Ease of dissolution*. With no co-owners or partners, the sole proprietor can sell the business or close the doors at any time, making this form of business organization an ideal way to test a new business idea.

Disadvantages of Sole Proprietorships

Along with the freedom to operate the business as they wish, sole proprietors face several disadvantages:

- *Unlimited liability.* From a legal standpoint, the sole proprietor and the company are one and the same, making the business owner personally responsible for all debts the company incurs, even if they exceed the company's value. The owner may need to sell other personal property—their car, home, or other investments—to satisfy claims against the business.

- *Difficulty raising capital.* Business assets are unprotected against claims of personal creditors, so business lenders view sole proprietorships as high risk due to the owner's unlimited liability. Owners must often use personal funds—borrowing on credit cards, second-mortgaging their homes, or selling investments—to finance their business. Expansion plans can also be affected by an inability to raise additional funding.
- *Limited managerial expertise.* The success of a sole proprietorship rests solely with the skills and talents of the owner, who must wear many different hats and make all decisions. Owners are often not equally skilled in all areas of running a business. A graphic designer may be a wonderful artist but not know bookkeeping, how to manage production, or how to market their work.
- *Trouble finding qualified employees.* Sole proprietors often cannot offer the same pay, fringe benefits, and advancement as larger companies, making them less attractive to employees seeking the most favorable employment opportunities.
- *Personal time commitment.* Running a sole proprietorship business requires personal sacrifices and a huge time commitment, often dominating the owner's life with 12-hour workdays and 7-day workweeks.
- *Unstable business life.* The life span of a sole proprietorship can be uncertain. The owner may lose interest, experience ill health, retire, or die. The business will cease to exist unless the owner makes provisions for it to continue operating or puts it up for sale.
- *Losses are the owner's responsibility.* The sole proprietor is responsible for all losses, although tax laws allow these to be deducted from other personal income.

The sole proprietorship may be a suitable choice for a one-person start-up operation with no employees and little risk of liability exposure. For many sole proprietors, however, this is a temporary choice, and as the business grows, the owner may be unable to operate with limited financial and managerial resources. At this point, the owner may decide to take in one or more partners to ensure that the business continues to flourish.

CATCHING THE ENTREPRENEURIAL SPIRIT

Work-Life Balance Important in Small Business

According to a survey released by the Wells Fargo/Gallup Small Business Index, about two-thirds of small business owners are satisfied with how they balance their personal lives and work schedules, and the New York Enterprise Report survey found that they work twice as much as regular employees. The survey also found that 33 percent of small business owners work more than 50 hours per week, while 25 percent reported working over 60 hours per week. A survey by Gallup finds 39 percent of small business owners working over 60 hours per week.

The 2016 Annual Bank of the West Small Business Growth Survey found that 62 percent of the respondents reported the stress of ownership as worse than what they had originally imagined. At the same time, the same people indicated that being a small business owner puts them in charge of their destiny, offers freedom, and is more rewarding than ever imagined. Over two-thirds of small business owners, according to a survey, said they were satisfied with their personal work-life balance, and almost 90 percent said they were satisfied with being a small business owner in general. Dennis Jacobe, chief economist at Gallup, argues, "People see the benefits more closely tied to them when they're the owner," he says. "Working hard and long is a natural aspect of the kind of people willing to start their own business."

But if employees have trouble balancing work and life, odds are they will have less confidence in you as a leader, a recent study shows. The study, which polled more than 50,000 U.S. workers from various markets including professional services, consumer goods, and financial services, found that employees who strike a positive balance between home and work were 11 percent more likely to praise their leaders' ability to set a clear direction.

The Society for Human Resource Management's (SHRM) research also shows work-life balance has a great impact on how employees feel about their leaders. Jennifer Schramm, a manager in SHRM's workplace trends and forecasting research department, predicts that as companies try to maximize the productivity of each employee, work-life balance and the resulting employee satisfaction will become increasingly more important. And research shows that happy employees can yield happy returns for businesses.

Critical Thinking Questions

1. Many small business owners expect their employees to be as committed and to work as hard as they do. How would you avoid falling into that trap while still demanding the best from your workers?

2. As a small business owner, consider some strategies to ensure an appropriate work-life balance for your employees.

Sources: Brian Sutter, “How Hard Small Business Owners Work,” SCORE, https://www.score.org, accessed August 17, 2017; The Hartford Insurance Company, “2015 Small Business Success Study,” accessed August 17, 2017; Michelle Di Gangi, "Attitude check: Small business owners say it's all worth it," July 26, 2016, Bank of the West; 2016 Annual Bank of the West Small Business Growth Survey, conducted by Harris Poll, July 26, 2016; Jena Wuu, “Work-Life Not an Issue for Owners,” *Inc*., http://www.inc.com, August 10, 2005; Christina Galoozis, “Employees View Leadership Through Lens of Work-Life Balance,” *Inc*.,http://www.inc.com, June 8, 2005.

CONCEPT CHECK

1. What is a sole proprietorship?
2. Why is this a popular form of business organization?
3. What are the drawbacks to being a sole proprietor?

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11.3: Partnerships- Sharing the Load

What are the advantages of operating as a partnership, and what downside risks should partners consider?

Can **partnerships**, an association of two or more individuals who agree to operate a business together for profit, be hazardous to a business's health? Let's assume partners Ron and Liz own a stylish and successful beauty salon. After a few years of operating the business, they find they have contrasting visions for their company. Liz is happy with the status quo, while Ron wants to expand the business by bringing in investors and opening salons in other locations.

How do they resolve this impasse? By asking themselves some tough questions. Whose view of the future is more realistic? Does the business actually have the expansion potential Ron believes it does? Where will he find investors to make his dream of multiple locations a reality? Is he willing to dissolve the partnership and start over again on his own? And who would have the right to their clients?

Ron realizes that expanding the business in line with his vision would require a large financial risk and that his partnership with Liz offers many advantages he would miss in a sole proprietorship form of business organization. After much consideration, he decides to leave things as they are.

For those individuals who do not like to "go it alone," a partnership is relatively simple to set up. Offering a shared form of business ownership, it is a popular choice for professional-service firms such as lawyers, accountants, architects, stockbrokers, and real estate companies.

The parties agree, *either orally or in writing*, to share in the profits and losses of a joint enterprise. A *written partnership agreement*, spelling out the terms and conditions of the partnership, *is recommended* to prevent later conflicts between the partners. Such agreements typically include the name of the partnership, its purpose, and the contributions of each partner (financial, asset, skill/talent). It also outlines the responsibilities and duties of each partner and their compensation structure (salary, profit sharing, etc.). It should contain provisions for the addition of new partners, the sale of partnership interests, and procedures for resolving conflicts, dissolving the business, and distributing the assets.

There are two basic types of partnerships: *general and limited*. In a **general partnership**, all partners share in the management and profits. They co-own the assets, and each can act on behalf of the firm. Each partner also has unlimited liability for all the business obligations of the firm. A **limited partnership** has two types of partners: one or more **general partners**, who have unlimited liability, and one or more **limited partners**, whose liability is limited to the amount of their investment. In return for limited liability, limited partners agree not to take part in the day-to-day management of the firm. They help to finance the business, but the general partners maintain operational control.

There are also limited liability partnerships (LLP), which are similar to a general partnership except that partners are not held responsible for the business debt and liabilities. Another type is a limited liability limited partnership (LLLP), which is basically a limited partnership with addition of limited liability, hence protecting the general partner from the debt and liabilities of the partnership.

Advantages of Partnerships

Some advantages of partnerships come quickly to mind:

- *Ease of formation.* Like sole proprietorships, partnerships are easy to form. The partners agree to do business together and draw up a *partnership agreement.* For most partnerships, applicable state laws are not complex.
- *Availability of capital.* Because two or more people contribute financial resources, partnerships can raise funds more easily for operating expenses and business expansion. The partners' combined financial strength also increases the firm's ability to raise funds from outside sources.
- *Diversity of skills and expertise.* Partners share the responsibilities of managing and operating the business. Combining partner skills to set goals, manage the overall direction of the firm, and solve problems increases the chances for the partnership's success. To find the right partner, you must examine your own strengths and weaknesses and know what you need from a

partner. Ideal partnerships bring together people with complementary backgrounds rather than those with similar experience, skills, and talents. In Table 4.2 you'll find some advice on choosing a partner.

- *Flexibility.* General partners are actively involved in managing their firm and can respond quickly to changes in the business environment.
- *No special taxes.* Partnerships pay no income taxes. A partnership must file a partnership return with the Internal Revenue Service, reporting how profits or losses were divided among the partners. Each partner's profit or loss is then reported on the partner's personal income tax return, with any profits taxed at personal income tax rates.
- *Relative freedom from government control.* Except for state rules for licensing and permits, the government has little control over partnership activities.

Table 4.2

Perfect Partners
Picking a partner is both an art and a science. Someone may have all the right credentials on paper, but does that person share your vision and the ideas you have for your company? Are they a straight shooter? Honesty, integrity, and ethics are important, because you may be liable for what your partner does. Be prepared to talk about everything, and trust your intuition and your gut feelings—they're probably right. Ask yourself and your potential partner the following questions—then see how well your answers match up: 1. Why do you want a partner? 2. What characteristics, talents, and skills does each person bring to the partnership? 3. How will you divide responsibilities—from long-range planning to daily operations? Who will handle such tasks as marketing, sales, accounting, and customer service? 4. What is your long-term vision for the business—its size, life span, financial commitment, etc.? 5. What are your personal reasons for forming this company? Are you looking to create a small company or build a large one? Are you seeking a steady paycheck or financial independence? 6. Will all parties put in the same amount of time, or is there an alternative arrangement that is acceptable to everyone? 7. Do you have similar work ethics and values? 8. What requirements will be in the partnership agreement?

Disadvantages of Partnerships

Business owners must consider the following disadvantages of setting up their company as a partnership:

- *Unlimited liability*. All general partners have unlimited liability for the debts of the business. In fact, any one partner can be held personally liable for all partnership debts and legal judgments (such as malpractice)—regardless of who caused them. As with sole proprietorships, business failure can lead to a loss of the general partners' personal assets. To overcome this problem, many states now allow the formation of *limited liability partnerships (LLPs),*which protect each individual partner from responsibility for the acts of other partners and limit their liability to harm resulting from their own actions.
- *Potential for conflicts between partners.* Partners may have different ideas about how to run their business, which employees to hire, how to allocate responsibilities, and when to expand. Differences in personalities and work styles can cause clashes or breakdowns in communication, sometimes requiring outside intervention to save the business.
- *Complexity of profit sharing.* Dividing the profits is relatively easy if all partners contribute equal amounts of time, expertise, and capital. But if one partner puts in more money and others more time, it might be more difficult to arrive at a fair profit-sharing formula.
- *Difficulty exiting or dissolving a partnership.* As a rule, partnerships are easier to form than to leave. When one partner wants to leave, the value of their share must be calculated. To whom will that share be sold, and will that person be acceptable to the other partners? If a partner who owns more than 50 percent of the entity withdraws, dies, or becomes disabled, the partnership must reorganize or end. To avoid these problems, most partnership agreements include specific guidelines for transferring partnership interests and buy–sell agreements that make provision for surviving partners to buy a deceased partner's interest. Partners can also purchase special life insurance policies designed to fund such a purchase.

Business partnerships are often compared to marriages. As with a marriage, choosing the right partner is critical. So if you are considering forming a partnership, allow plenty of time to evaluate your and your potential partner's goals, personality, expertise, and working style before joining forces.

CONCEPT CHECK

1. How does a partnership differ from a sole proprietorship?
2. Describe the four main types of partnerships, and explain the difference between a limited partner and a general partner.
3. What are the main advantages and disadvantages of a partnership?

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11.4: Corporations- Limiting Your Liability

How does the corporate structure provide advantages and disadvantages to a company, and what are the major types of corporations?

When people think of corporations, they typically think of major, well-known companies, such as Apple, Alphabet (parent company of Google), Netflix, IBM, Microsoft, Boeing, and General Electric. But corporations range in size from large multinationals with thousands of employees and billions of dollars in sales to midsize or even smaller firms with few employees and revenues under $25,000.

A **corporation** is a legal entity subject to the laws of the state in which it is formed, where the right to operate as a business is issued by state charter. A corporation can own property, enter into contracts, sue and be sued, and engage in business operations under the terms of its charter. Unlike sole proprietorships and partnerships, corporations are taxable entities with a life separate from their owners, who are not personally liable for its debts.

When launching her company, Executive Property Management Services, Inc., 32-year-old Linda Ravden realized she needed the liability protection of the corporate form of business organization. Her company specialized in providing customized property management services to mid- and upper-level corporate executives on extended work assignments abroad, often for three to five years or longer. Taking care of substantial properties in the million-dollar range and above was no small responsibility for Ravden's company. Therefore, the protection of a corporate business structure, along with carefully detailed contracts outlining the company's obligations, were crucial in providing Ravden with the liability protection she needed—and the peace of mind to focus on running her business without constant worry. Note that an LLC does not provide unlimited protection; you can still get in trouble for such things as mingling personal and business funds.[2]

MANAGING CHANGE

Pacific Sun's Golden Glow

It all started as a little surf shop in 1980 in Newport Beach, California. It wasn't called PacSun then. It wasn't even all that different from other shops carrying surfboards and wax, except for one thing. The founders had a better idea.

During Southern California's wet, cool winters, the beaches got empty, and the surf store business went dry. Where did everyone go? To the mall, of course. Their idea—to be the first surf shop to move into California's popular mall locations—worked. The company soon grew to 21 stores, selling such popular name brands as Billabong, Gotcha, CatchIt, Stussy, and Quiksilver, as well as its own private-label brands.

What began as a little surf shop became a leading mall-based specialty retailer in the fast-growing surf, skate, and hip-hop apparel markets. With close to a thousand stores in the United States and Puerto Rico and sales topping $1 billion, how did the founders make the leap from selling and waxing surfboards to being a major player in the youth apparel market? How has Pacific Sunwear of California, Inc. (**http://www.pacsun.com**) succeeded when thousands of other clothing companies failed?

"We listen and we change," says the CEO of Pacific Sun. "The kids have the answers, so we listen to get the trends, the solutions, and find out what we are doing right." To remain on the cutting edge of teen tastes, the company hosts an open house every Wednesday at its corporate headquarters in Anaheim, California, where vendors present their wares to PacSun's savvy team of buyers. Being able to distinguish between short-lived fads and actual trends is important when making merchandise choices. The company's focus on "active brand management" is what kept its sales climbing.

The founders' philosophy had served their business well. In 1993, the 60-store company sold stock to the public. It had grown to over 1,000 stores in 50 states and Puerto Rico, with 12,000 employees. The company's PacSun stores cater to a completely different customer than its d.e.m.o. hip-hop stores. In April 2006, PacSun launched its third concept, One Thousand Steps, a footwear store.

With changing trends and online shopping challenges facing many brick-and-mortar retailers, companies such as Wet Seal and Quicksilver filed for bankruptcy in 2015, and PacSun filed for bankruptcy in April 2016. At the time of bankruptcy filing, the company had 593 PacSun stores employing approximately 2,000 employees. In September 2016, PacSun emerged from the

bankruptcy after it cut debt and closed stores. The company also turned over all of its stock to the private equity firm Golden Gate Capital, its senior lender.

As its business took off, PacSun successfully made the leap from the small sole proprietorship form of business organization to corporate retailing giant. Facing changing trends and technologies, the firm hit a bump in the road and is working hard to reestablish. The company is indeed a thousand steps away from its humble beginnings.

Critical Thinking Questions

1. How did PacSun manage its evolution from a small, local business to a leading mall-based specialty retailer? What could be the reasons for its missteps resulting in the bankruptcy filing?
2. What form of business organization might PacSun have chosen when it started, and what might have prompted it to change as it grew?

Sources: Marie Driscoll, "Pacific Sun's Golden Glow," *Business Week Online*, November 9, 2004, http://www.businessweek.com; Ron Ehlers (VP Information Services, Pacific Sunwear of California, Inc.) "Pacific Sunwear: Maintain a Fresh Brand by Anticipating Consumer Needs," presentation to the Retail Systems MIX Summit, May 25, 2005, http://www.retailsystems.com; "Corporate Profile," Pacific Sun corporate Web site, http://www.pacsun.com; Samantha Masunaga, "PacSun files for Chapter 11 bankruptcy protection, plans to go private," *Los Angeles Times*, http://www.latimes.com, accessed August 17, 2017; Steven Church, "Pacific Sunwear Has 'Retailer's Dream' as Bankruptcy Wraps Up," *Bloomberg*, https://www.bloomberg.com, accessed August 2017.

Corporations play an important role in the U.S. economy. As **Table 4.1**demonstrated, corporations account for only 18 percent of all businesses but generate 81 percent of all revenues and 58 percent of all profits. Company type and size vary; however, when you look at the top companies by revenue in the United States or globally, they include many familiar names that affect our daily lives.

In the United States, according to *Fortune* magazine, the top three corporations in the 2017 were (1) Walmart Stores (revenue: $485.9 B), (2) Berkshire Hathaway(revenue: $223.6 B), and (3) Apple (revenue: $215.6 B), whereas *Forbes* magazine found that the top three corporations were (1) Berkshire Hathaway (revenue: $222.9B), (2) Apple (revenue: $217.5B), and (3) JPMorgan Chase (revenue: $102.5B). By comparison, the top three companies in 2017 according to the *World Economic Forum* were (1) Apple, (2) Alphabet, and (3) Microsoft. These corporations rise and fall on the various lists based on their revenue in a given year and how the organizations measure revenue and the time frames that they use.[3]

The Incorporation Process

Setting up a corporation is more complex than starting a sole proprietorship or partnership. Most states base their laws for chartering corporations on the Model Business Corporation Act of the American Bar Association, although registration procedures, fees, taxes, and laws that regulate corporations vary from state to state.



Exhibit 4.2: Incorporated in 1969, Walmart is one of America's most popular retail stores. Opened as Walmart Discount City by retailer Sam Walton in 1962, the retailer quickly established a strong brand image. Today, Walmart operates in more than 28 countries, and the Walmart icon is among the most recognizable trademarks in all of business. *What steps must companies take to become incorporated?* (Credit: Mike Mozart/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

A firm does not have to incorporate in the state where it is based and may benefit by comparing the rules of several states before choosing a state of incorporation. Although Delaware is a small state with few corporations actually based there, its procorporate policies make it the state of incorporation for many companies, including about half the Fortune 500. Incorporating a company involves five main steps:

- Selecting the company's name
- Writing the *articles of incorporation* (see Table 4.3) and filing them with the appropriate state office, usually the secretary of state
- Paying required fees and taxes
- Holding an organizational meeting
- Adopting bylaws, electing directors, and passing the first operating resolutions

The state issues a corporate charter based on information in the articles of incorporation. Once the corporation has its charter, it holds an organizational meeting to adopt bylaws, elect directors, and pass initial operating resolutions. Bylaws provide legal and managerial guidelines for operating the firm.

Table 4.3

Articles of Incorporation
Articles of incorporation are prepared on a form authorized or supplied by the state of incorporation. Although they may vary slightly from state to state, all articles of incorporation include the following key items: • Name of corporation • Company's goals • Types of stock and number of shares of each type to issue • Life of the corporation (usually "perpetual," meaning with no time limit) • Minimum investment by owners • Methods for transferring shares of stock • Address of the corporate office • Names and addresses of the first board of directors

The Corporate Structure

As **Exhibit 4.4** shows, corporations have their own organizational structure with three important components: stockholders, directors, and officers.

Stockholders (or shareholders) are the owners of a corporation, holding shares of stock that provide them with certain rights. They may receive a portion of the corporation's profits in the form of dividends, and they can sell or transfer their ownership in the corporation (represented by their shares of stock) at any time. Stockholders can attend annual meetings, elect the board of directors, and vote on matters that affect the corporation in accordance with its charter and bylaws. Each share of stock generally carries one vote.

The stockholders elect a **board of directors** to govern and handle the overall management of the corporation. The directors set major corporate goals and policies, hire corporate officers, and oversee the firm's operations and finances. Small firms may have as few as 3 directors, whereas large corporations usually have 10 to 15.

The boards of large corporations typically include both corporate executives and outside directors (not employed by the organization) chosen for their professional and personal expertise. Outside directors often bring a fresh view to the corporation's activities because they are independent of the firm.

Hired by the board, the *officers* of a corporation are its top management and include the president and chief executive officer (CEO), vice presidents, treasurer, and secretary, who are responsible for achieving corporate goals and policies. Officers may also be board members and stockholders.

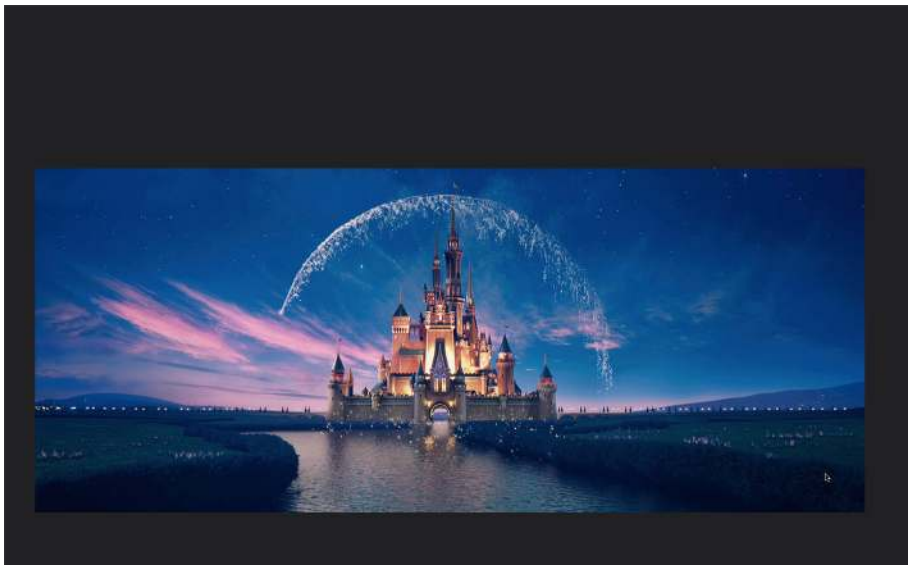


Exhibit 4.3: When Walt Disney cast his now-famous mouse as Steamboat Willie back in the 1920s, he had little idea that his animation project would turn into one of the largest entertainment companies in the world. The house that Walt built, with its magical theme parks, movie studios, and product lines, is overseen today by visionary directors with accomplished backgrounds in media, technology, and government. *What important tasks and responsibilities are entrusted to Disney's board of directors?* (Marc Levin/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Advantages of Corporations

The corporate structure allows companies to merge financial and human resources into enterprises with great potential for growth and profits:

- *Limited liability.* A key advantage of corporations is that they are separate legal entities that exist apart from their owners. Owners' (stockholders') liability for the obligations of the firm is limited to the amount of the stock they own. If the corporation goes bankrupt, creditors can look only to the assets of the corporation for payment.
- *Ease of transferring ownership.* Stockholders of public corporations can sell their shares at any time without affecting the status of the corporation.

- *Unlimited life.* The life of a corporation is unlimited. Although corporate charters specify a life term, they also include rules for renewal. Because the corporation is an entity separate from its owners, the death or withdrawal of an owner does not affect its existence, unlike a sole proprietorship or partnership.
- *Tax deductions.* Corporations are allowed certain tax deductions, such as operating expenses, which reduces their taxable income.
- *Ability to attract financing.* Corporations can raise money by selling new shares of stock. Dividing ownership into smaller units makes it affordable to more investors, who can purchase one or several thousand shares. The large size and stability of corporations also helps them get bank financing. All these financial resources allow corporations to invest in facilities and human resources and expand beyond the scope of sole proprietorships or partnerships. It would be impossible for a sole proprietorship or partnership to make automobiles, provide nationwide telecommunications, or build oil or chemical refineries.

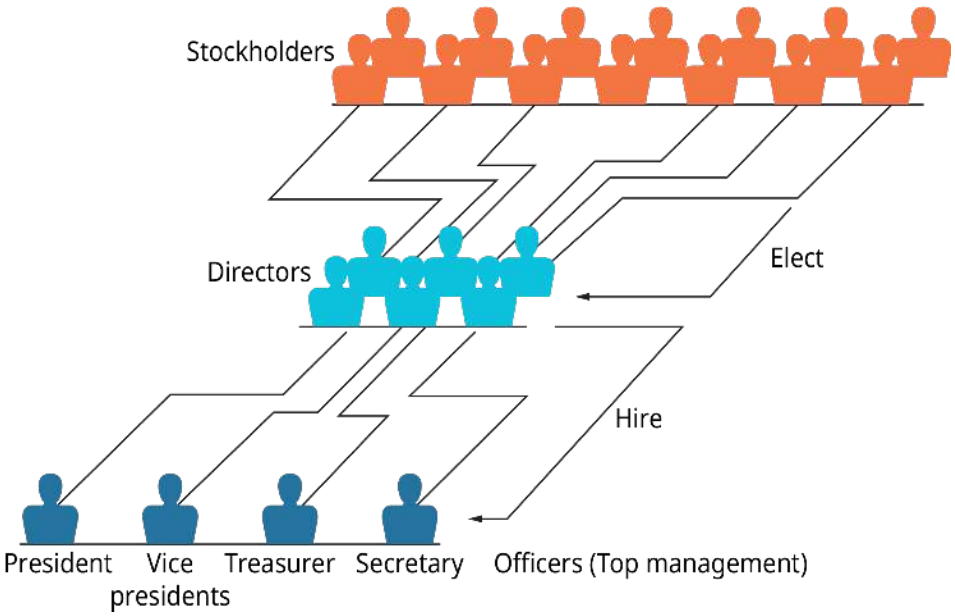


Exhibit 4.4: **Organizational Structure of Corporations** Attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license

Disadvantages of Corporations

Although corporations offer companies many benefits, they have some disadvantages:

- *Double taxation of profits.* Corporations must pay federal and state income taxes on their profits. In addition, any profits (dividends) paid to stockholders are taxed as personal income, although at a somewhat reduced rate.
- *Cost and complexity of formation.* As outlined earlier, forming a corporation involves several steps, and costs can run into thousands of dollars, including state filing, registration, and license fees, as well as the cost of attorneys and accountants.
- *More government restrictions.* Unlike sole proprietorships and partnerships, corporations are subject to many regulations and reporting requirements. For example, corporations must register in each state where they do business and must also register with the Securities and Exchange Commission (SEC) before selling stock to the public. Unless it is closely held (owned by a small group of stockholders), a firm must publish financial reports on a regular basis and file other special reports with the SEC and state and federal agencies. These reporting requirements can impose substantial costs, and published information on corporate operations may also give competitors an advantage.

Types of Corporations

Three types of corporate business organization provide limited liability.

The **C corporation** is the conventional or basic form of corporate organization. Small businesses may achieve liability protection through S corporations or limited liability companies (LLCs).

An **S corporation** is a hybrid entity, allowing smaller corporations to avoid double taxation of corporate profits as long as they meet certain size and ownership requirements. Organized like a corporation with stockholders, directors, and officers, an S

corporation is taxed like a partnership. Income and losses flow through to the stockholders and are taxed as personal income. S corporations are allowed a maximum of 100 qualifying shareholders and one class of stock. The owners of an S corporation are not personally liable for the debts of the corporation.

A newer type of business entity, the **limited liability company (LLC)**, is also a hybrid organization. Like S corporations, they appeal to small businesses because they are easy to set up and not subject to many restrictions. LLCs offer the same liability protection as corporations as well as the option of being taxed as a partnership or a corporation. First authorized in Wyoming in 1977, LLCs became popular after a 1988 tax ruling that treats them like partnerships for tax purposes. Today all states allow the formation of LLCs.

Table 4.4 summarizes the advantages and disadvantages of each form of business ownership.

Table 4.4: Advantages and Disadvantages of Major Types of Business Organization

Sole Proprietorship	Partnership	Corporation
Advantages		
Owner receives all profits.	More expertise and managerial skill available.	Limited liability protects owners from losing more than they invest.
Low organizational costs.	Relatively low organizational costs.	Can achieve large size due to marketability of stock (ownership).
Income taxed as personal income of proprietor.	Income taxed as personal income of partners.	Receives certain tax advantages.
Independence.	Fundraising ability is enhanced by more owners.	Greater access to financial resources allows growth.
Secrecy.		Can attract employees with specialized skills.
Ease of dissolution.		Ownership is readily transferable.
		Long life of firm (not affected by death of owners).
Disadvantages		
Owner receives all losses.	Owners have unlimited liability; may have to cover debts of other, less financially sound partners.	Double taxation because both corporate profits and dividends paid to owners are taxed, although the dividends are taxed at a reduced rate.
Owner has unlimited liability; total wealth can be taken to satisfy business debts.	Dissolves or must reorganize when partner dies.	More expensive and complex to form.
Limited fundraising ability can inhibit growth.	Difficult to liquidate or terminate.	Subject to more government regulation.
Proprietor may have limited skills and management expertise.	Potential for conflicts between partners.	Financial reporting requirements make operations public.
Few long-range opportunities and benefits for employees.	Difficult to achieve large-scale operations.	
Lacks continuity when owner dies.		

CONCEPT CHECK

1. What is a corporation? Describe how corporations are formed and structured.
2. Summarize the advantages and disadvantages of corporations. Which features contribute to the dominance of corporations in the business world?
3. Why do S corporations and limited liability companies (LLCs) appeal to small businesses?

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11.5: Specialized Forms of Business Organization

What other options for business organization does a company have in addition to sole proprietorships, partnerships, and corporations?

In addition to the three main forms, several specialized types of business organization also play an important role in our economy. We will look at cooperatives and joint ventures in this section and take a detailed look at franchising in the following section.

Cooperatives

When you eat a Sunkist orange or spread Land O'Lakes butter on your toast, you are consuming foods produced by cooperatives. A **cooperative** is a legal entity with several *corporate features*, such as limited liability, an unlimited life span, an elected board of directors, and an administrative staff. Member-owners pay annual fees to the cooperative and share in the profits, which are distributed to members in proportion to their contributions. Because they do not retain any profits, cooperatives are not subject to taxes.

There are currently 2.6 million cooperatives with one billion members employing more than 12.5 million employees in more than 145 countries worldwide.[4]Cooperatives operate in every industry, including agriculture, childcare, energy, financial services, food retailing and distribution, health care, insurance, housing, purchasing and shared services, and telecommunications, among others. They range in size from large enterprises such as Fortune 500 companies to small local storefronts and fall into four distinct categories: consumer, producer, worker, and purchasing/shared services.

Cooperatives are autonomous businesses owned and democratically controlled by their members—the people who buy their goods or use their services—not by investors. Unlike investor-owned businesses, cooperatives are organized solely to meet the needs of the member-owners, not to accumulate capital for investors. As democratically controlled businesses, many cooperatives practice the principle of "one member, one vote," providing members with equal control over the cooperative.

There are two types of cooperatives. **Buyer cooperatives** combine members' purchasing power. Pooling buying power and buying in volume increases purchasing power and efficiency, resulting in lower prices. At the end of the year, members get shares of the profits based on how much they bought. Obtaining discounts to lower costs gives the corner Ace Hardware store the chance to survive against retailing giants such as Home Depot Inc. and Lowe's.

Founded in 1924, Ace Hardware is one of the nation's largest cooperatives and is wholly owned by its independent hardware retailer members in stores spanning all 50 states and 70 countries. In August 2017, Ace opened its 5,000th store. In 2017, the company reported its revenues in the second quarter were $1.5 billion, which was an increase of 4.6 percent from 2016's second quarter. The net income for the second quarter of 2017 was $51.1 million.[5]

Seller cooperatives are popular in agriculture, wherein individual producers join to compete more effectively with large producers. Member dues support market development, national advertising, and other business activities. In addition to Sunkist and Land O'Lakes, other familiar cooperatives are Calavo (avocados), Ocean Spray (cranberries and juices), and Blue Diamond (nuts). CHS Inc., the largest cooperative in the United States, sells energy, supply, food, and grain.

Cooperatives empower people to improve their quality of life and enhance their economic opportunities through self-help. Throughout the world, cooperatives are providing members with credit and financial services, energy, consumer goods, affordable housing, telecommunications, and other services that would not otherwise be available to them. There are several principles that cooperatives must follow, according to San Luis Valley REC, International Co-operative Alliance, and Daman Prakash, author of *The Principles of Cooperation*. They include (1) open membership, which means that cooperatives are open to all people to use its services; (2) democratic member control, which means that organizations are controlled by their members; (3) members' economic participation, which means that members contribute equally to the capital of the cooperative; (4) autonomy, which means cooperatives are self-help organizations controlled by their members; and (5) education and training, which means that cooperatives provide education and training for their members while also electing representatives, managers, and employees.[6]

Joint Ventures

In a **joint venture**, two or more companies form an alliance to pursue a specific project, usually for a specified time period. There are many reasons for joint ventures. The project may be too large for one company to handle on its own, and joint ventures also

afford companies access to new markets, products, or technology. Both large and small companies can benefit from joint ventures.

In 2005, South Korea's Hyundai Motor Company announced it signed a $1.24 billion deal to form a joint venture with China's Guangzhou Automobile Group. The arrangement gave the South Korean automaker access to the commercial vehicle market in China, where its passenger cars are already the top selling foreign brand. Each side will hold equal stakes in the new entity, named Guangzhou Hyundai Motor Company. The new plant began production in 2007 with an annual capacity of 200,000 units producing small to large trucks and buses as well as commercial vehicles. According to Reuters, Hyundai made plans to build a fifth factory in China. With five factories in operation, Hyundai's annual Chinese production capacity will be 1.65 million vehicles.[7]

CONCEPT CHECK

1. Describe the two types of cooperatives and the advantages of each.
2. What are the benefits of joint ventures?

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11.6: Franchising- A Popular Trend

What makes franchising an appropriate form of organization for some types of business, and why does it continue to grow in importance?

When Shep Bostin decided to buy a franchise, he researched the usual suspects: Jiffy Lube, McDonald's, and Quiznos Subs. Bostin, then 38, was a top executive at a dying Gaithersburg, Maryland, technology firm, but instead of becoming another McDonald's franchisee, Bostin chose to remain a geek, albeit one who wheeled around in the signature black PT Cruiser of Geeks On Call, a company that provides on-site computer assistance via a large pool of experienced techies. Bostin made residential and commercial "house calls" for more than a decade as a Geeks On Callfranchisee. There are approximately 123 independently owned and operated Geeks On Call franchise territories in 50 states serving over 250,000 customers.[8]

Choosing the right franchise can be challenging. Franchises come in all sizes and demand different skills and qualifications. And with somewhere around 2,500 different franchised businesses in the United States, Bostin had a lot to choose from—from cookie-bouquet peddlers and dog trainers to acupuncture specialists. Table 4.5 shows the top franchises for 2017 from various sources. *Entrepreneur*'s rankings utilize among other factors costs/fees, brand strength, support, and financial strength. *Franchise Business Review* focuses on owner satisfaction, whereas *Franchise Gator* utilizes a formula with factors such as financial stability and engagement.



Exhibit 4.5: Chance the Rapper was a big winner at the 2017 Grammy Awards. His win was also validation for a new business model. Chance the Rapper does not have a deal with a traditional record label but instead releases his music through streaming services. *How might this approach benefit other aspiring music artists to gain footing and become a force in the music industry?* (Credit: Julio Enriquez/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Table 4.5 Sources: "2017 Franchise 500 Ranking, Franchise 500 2017," *https://www.entrepreneur.com/franchise500* (August 17, 2017); "Top Franchise Opportunities for 2017," Franchise Business Review, topfranchises.franchisebusinessreview.com/, (August 17, 2017); "Top 100 Franchises of 2017," Franchise Gator, https://www.franchisegator.com/lists/top-100/, (August 17, 2017).

Top 10 Franchises for 2017	
Entrepreneur Top 10	
Franchise	**Initial investment**
1. 7-Eleven Inc.	$37K to $1.6M
2. McDonald's	$1M to $2.2M
3. Dunkin' Donuts	$229K to $1.7M
4. The UPS Store	$178K to $403K
5. Jimmy John's Gourmet Sandwiches	$330K to $558K
6. Dairy Queen	$1.1M to $1.9M
7. Ace Hardware Corp.	$273K to $1.6M
8. Wingstop Restaurant Inc.	$303K to $923K
9. Sport Clips	$189K to $355K
10. RE/MAX LLC	$38K to $224K
Franchise Business Review Top 10	
Franchise Name/ Industry	**Minimum Investment**
Visiting Angels (Senior care)	$77,985
MaidPro (Cleaning and maintenance)	$74,560
Pinot's Palette (Sports and recreation)	$63,400
Christian Brothers Automotive (Automotive)	$146,693
Home Instead Senior Care (Senior care)	$463,698
Our Town America (Advertising and Sales)	$115,000
FASTSIGNS (Business services)	$63,300
Sandler Training (Business services)	$182,329
Soccer Shots ((Child services)	$88,150
Two Men and a Truck (Services)	$36,000
Franchise Gator Top 10	
Franchise Name	**Minimum Cash Required**
Fast Signs	$100,000
Tropical Smoothie Cafe	$100,000
Marco's Pizza	$100,000
Zoup	$100,000
Mathnasium	$100,000
Christian Brothers Automotive	$80,000
Two Men and a Truck	$150,000

Top 10 Franchises for 2017	
Kiddie Academy	$200,000
Wild Birds Unlimited	$40,000
SportClips	$200,000

Chances are you recognize some of the names listed in Table 4.5 and deal with franchise systems in your neighborhood every day. When you have lunch at **Taco Bell** or Jamba Juice, make copies at FedEx Office, change your oil at Jiffy Lube, buy candles at Wicks 'n' Sticks, or mail a package at The UPS Store, you are dealing with a franchised business. These and other familiar name brands mean quality, consistency, and value to consumers. Franchised businesses provided about 8.9 million direct jobs with a $890 billion economic output for the U.S. economy.[9]

Franchising is a form of business organization that involves a **franchisor**, the company supplying the product or service concept, and the **franchisee**, the individual or company selling the goods or services in a certain geographic area. The franchisee buys a package that includes a proven product or service, proven operating methods, and training in managing the business. Offering a way to own a business without starting it from scratch and to expand operations quickly into new geographic areas with limited capital investment, franchising is one of the fastest growing segments of the economy. If you are interested in franchising, food companies represent the largest number of franchises.

A **franchise agreement** is a contract that allows the franchisee to use the franchisor's business name, trademark, and logo. The agreement also outlines rules for running the franchise, services provided by the franchisor, and financial terms. The franchisee agrees to follow the franchisor's operating rules by keeping inventory at certain levels, buying a standard equipment package, keeping up sales and service levels, taking part in franchisor promotions, and maintaining a relationship with the franchisor. In return, the franchisor provides the use of a proven company name and symbols, help in finding a site, building plans, guidance and training, management assistance, managerial and accounting systems and procedures, employee training, wholesale prices for supplies, and financial assistance.

Advantages of Franchises

Like other forms of business organization, franchising offers some distinct advantages:

- *Increased ability for franchisor to expand.* Because franchisees finance their own units, franchisors can grow without making a major investment.
- *Recognized name, product, and operating concept.* Consumers know they can depend on products from franchises such as Pizza Hut, Hertz, and Holiday Inn. As a result, the franchisee's risk is reduced and the opportunity for success increased. The franchisee gets a widely known and accepted business with a proven track record, as well as operating procedures, standard goods and services, and national advertising.
- *Management training and assistance.* The franchisor provides a structured training program that gives the new franchisee a crash course in how to start and operate their business. Ongoing training programs for managers and employees are another plus. In addition, franchisees have a peer group for support and sharing ideas.
- *Financial assistance.* Being linked to a nationally known company can help a franchisee obtain funds from a lender. Also, the franchisor typically gives the franchisee advice on financial management, referrals to lenders, and help in preparing loan applications. Many franchisors also offer short-term credit for buying supplies, payment plans, and loans to purchase real estate and equipment. Although franchisors give up a share of profits to their franchisees, they receive ongoing revenues in the form of royalty payments.



Exhibit 4.6: Countless franchise opportunities exist for entrepreneurs with access to start-up capital. Despite the broad range of franchise opportunities available, lists of the fastest-growing franchises are heavily weighted with restaurant chains and cleaning services. Start-up costs for a Quiznos franchise can be pricey; expenses associated with opening a Club Pilates franchise or a Visiting Angels adult care service are significantly lower. *How do entrepreneurs evaluate which franchising opportunity is right for them?* (Credit: Mr. Blue Mau Mau/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Disadvantages of Franchises

Franchising also has some disadvantages:

- *Loss of control.* The franchisor has to give up some control over operations and has less control over its franchisees than over company employees.
- *Cost of franchising.* Franchising can be a costly form of business. Costs will vary depending on the type of business and may include expensive facilities and equipment. The franchisee also pays fees and/or royalties, which are usually tied to a percentage of sales. Fees for national and local advertising and management advice may add to a franchisee's ongoing costs.
- *Restricted operating freedom.* The franchisee agrees to conform to the franchisor's operating rules and facilities design, as well as inventory and supply standards. Some franchises require franchisees to purchase from only the franchisor or approved suppliers. The franchisor may also restrict the franchisee's territory or site, which could limit growth. Failure to conform to franchisor policies could mean the loss of the franchise.

Franchise Growth

Many of today's major franchise brands, such as McDonald's and KFC, started in the 1950s. Through the 1960s and 1970s, many more types of businesses—clothing, convenience stores, business services, and many others—used franchising to distribute their goods and services. Growth comes from expansion of established franchises—for example, Subway, Pizza Hut, and OrangeTheory Fitness—as well as new entrants such as those identified by *Entrepreneur* and *Franchise Gator*among other sources. According to *Entrepreneur* magazine, the top three new franchises in 2017 are (1) Mosquito Joe, (2) Blaze Fast-Fire'd Pizza, and (3) uBreakiFix, whereas according to *Franchise Gator,* the top three new franchises in 2017 are (1) Mosquito Joe, (2) Digital Doc, and (3) Nurse Next Door Home Healthcare Services. On both rankings, Mosquito Joe ranks at the top. Mosquito Joe provides mosquito control treatment services for both residential and commercial clients.[10]

Changing demographics drive franchise industry growth, in terms of who, how, and what experiences the most rapid growth. The continuing growth and popularity of technology and personal computing is responsible for the rapidly multiplying number of eBay drop-off stores, and tech consultants such as Geeks on Call are in greater demand than ever. Other growth franchise industries are the specialty coffee market, children's enrichment and tutoring programs, senior care, weight control, and fitness franchises.

The Next Big Thing in Franchising

All around you, people are talking about the next big thing—Subway is the new miracle weight-loss solution, the workout at OrangeTheory Fitness is the answer to America's fitness needs—and you are ready to take the plunge and buy a trendy franchise. But consumers' desires can change with the tide, so how do you plan an entrance—and exit—strategy when purchasing a franchise that's a big hit today but could be old news by tomorrow? Table 4.6 outlines some tips on purchasing a franchise.

International Franchising

Like other forms of business, franchising is part of our global marketplace economy. As international demand for all types of goods and services grows, most franchise systems are already operating internationally or planning to expand overseas. Restaurants, hotels, business services, educational products, car rentals, and nonfood retail stores are popular international franchises.

Franchisors in foreign countries face many of the same problems as other firms doing business abroad. In addition to tracking markets and currency changes, franchisors must understand local culture, language differences, and the political environment. Franchisors in foreign countries also face the challenge of aligning their business operations with the goals of their franchisees, who may be located half a globe away.

Table 4.6 Sources: "12 Things To Do Before You Buy a Franchise," *Forbes*,https://www.forbes.com, June 22, 2016; U.S. Small Business Administration, "6 Franchise Purchasing Tips," https://www.sba.gov, August 19, 2014; "5 Tips for Buying a Franchise," *Small Business Trends*, smalltrends.com, January 29, 2013.

Tips for Purchasing a Franchise
1. Take a personality test to determine the traits that will help and hurt you and assess your strengths and weaknesses.
2. Do your research about the franchise company, its services, and your potential location, and study the field.
3. Seek assistance from tax advisors and contract specialists.
4. Focus on financials: count your money, limit liability with appropriate business structure, and look beyond.
5. Beware of franchise consultants.
6. Use the franchise disclosure document to ensure everything is clear.
7. Utilize your instincts, and follow your gut.

Is Franchising in Your Future?

Are you ready to be a franchisee? Before taking the plunge, ask yourself some searching questions: Are you excited about a specific franchise concept? Are you willing to work hard and put in long hours? Do you have the necessary financial resources? Do you have prior business experience? Do your expectations and personal goals match the franchisor's?

Qualities that rank high on franchisors' lists are passion about the franchise concept, desire to be your own boss, willingness to make a substantial time commitment, assertiveness, optimism, patience, and integrity. Prior business experience is also a definite plus, and some franchisors prefer or require experience in their field.

EXPANDING AROUND THE GLOBE

Setting Up (Sandwich) Shop in China

Lured by China's fast-food industry, estimated today at $180 billion, Jim Bryant, 50, was not the only entrepreneur to discover it is hard to do business in China. In ten years, Bryant has opened 19 Subway stores in Beijing—only half the number he was supposed to have by now—while other companies such as Chili's and Dunkin' Donuts have given up their Chinese operations altogether.

Subway, or Sai Bei Wei (Mandarin for "tastes better than others"), is now the third-largest U.S. fast-food chain in China, right behind McDonald'sand KFC, and all its stores are profitable. Although Bryant had never eaten a Subway sandwich before, Jana Brands, the company Bryant worked for in China, sold $20 million in crab to Subway annually, so he knew it was big business. When Subway founder Fred DeLuca visited Beijing in 1994, Bryant took him to a place not on the official tour: McDonald's. It was Sunday night, and the place was packed. "We could open 20,000 Subways here and not scratch the surface," Bryant remembers DeLuca saying.

Two weeks later, Bryant called Subway's headquarters in Milford, Connecticut, and asked to be the company representative in China. He would recruit local entrepreneurs, train them to become franchisees, and act as a liaison between them and the company.

He would receive half the initial $10,000 franchise fee and one-third of their 8 percent royalty fees. He could also open his own Subway restaurants. Steve Forman, the founder of Jana Brands, invested $1 million in return for a 75 percent stake.

All foreign businesses in China had to be joint ventures with local partners, so Bryant used the Chinese business practice of relying on local relationships to find a manager for his first restaurant in Beijing. The project ran into problems immediately. Work on the store was delayed, and construction costs soared. It didn't take Bryant long to realize that he and Forman had been swindled out of $200,000.

When it finally opened, the restaurant was a hit among Americans in Beijing, but the locals weren't sure what to make of it. They didn't know how to order and didn't like the idea of touching their food, so they held the sandwich vertically, peeled off the paper, and ate it like a banana. Most of all, the Chinese didn't seem to want sandwiches.

But Subway did little to alter its menu—something that still irks some Chinese franchisees. "Subway should have at least one item tailored to Chinese tastes to show they respect local culture," says Luo Bing Ling, a Beijing franchisee. Bryant thinks that with time, sandwiches will catch on in China. Maybe he's right: Tuna salad, which he couldn't give away at first, is now the number one seller. Today there are nearly 600 Subway stores in China, with China's fast-food industry estimated at over $180 billion.

Critical Thinking Questions

1. What are some of the main problems U.S. franchisors encounter when attempting to expand their business in a country such as China?
2. What steps can franchisors take to ensure a smooth and successful launch of a new franchise business in a foreign country?

Sources: Subway, "Explore Our World," www.subway.com, accessed April 2, 2018; "Sales Revenue in Fast Food Restaurants in China 2011–2018," *Statista*, https://www.statista.com, accessed April 2, 2018; Carlye Adler, "How China Eats a Sandwich," *Fortune*, March 21, 2005, p. F210-B; Julie Bennett, "Chinese Market Offers Franchise Challenges," *Startup Journal–The Wall Street Journal Online*, http://www.startupjournal.com.

So what can you do to prepare when considering the purchase of a franchise? When evaluating franchise opportunities, professional guidance can prevent expensive mistakes, so interview advisers to find those that are right for you. Selecting an attorney with franchise experience will hasten the review of your franchise agreement. Getting to know your banker will speed up the loan process if you plan to finance your purchase with a bank loan, so stop by and introduce yourself. The proper real estate is a critical component for a successful retail franchise, so establish a relationship with a commercial real estate broker to begin scouting locations. Doing your homework can spell the difference between success and failure, and some early preparation can help lay the groundwork for the successful launch of your franchised business.

If the franchise route to business ownership seems right for you, begin educating yourself on the franchise process by investigating various franchise opportunities. You should research a franchise company thoroughly before making any financial commitment. Once you've narrowed your choices, ask for the *Uniform Franchise Offering Circular (UFOC)* for that franchisor, and read it thoroughly. The Federal Trade Commission (FTC) requires franchisors to prepare this document, which provides a wealth of information about the franchisor, including its history, operating style, management, past or pending litigation, the franchisee's financial obligations, and any restrictions on the sale of units. Interviewing current and past franchisees is another essential step. And most franchise systems use computers, so if you are not computer literate, take a class in the basics.

Would-be franchisees should also check recent issues of small-business magazines such as *Entrepreneur*, *Inc.*, *Startups*, and *Success* for industry trends, ideas on promising franchise opportunities, and advice on how to choose and run a franchise. The International Franchise Association website at **http://www.franchise.org** has links to *Franchising World* and other useful sites. (For other franchise-related sites, see the "Working the Net" questions.)

CONCEPT CHECK

1. Describe franchising and the main parties to the transaction.
2. Summarize the major advantages and disadvantages of franchising.
3. Why has franchising proved so popular?

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11.7: Mergers and Acquisitions

Why are mergers and acquisitions important to a company's overall growth?

A **merger** occurs when two or more firms combine to form one new company. For example, in 2016, Johnson Controls, a leading provider of building efficiency solutions, agreed to merge with Ireland's Tyco International, a leading provider of fire and security solutions, resulting in a company that will be a leader in products, technologies, and integrated solutions for the building and energy sectors. The merger is valued at $30 billion, with new Johnson Controls PLC to be based in Ireland. Currently, AT&T and Time Warner have an $85.4 billion merger pending. "Once we complete our acquisition of Time Warner Inc., we believe there is an opportunity to build an automated advertising platform that can do for premium video and TV advertising what the search and social media companies have done for digital advertising," AT&T's CEO Randall Stephenson said in a prepared statement. Mergers such as this one, in a well-established industry, can produce winning results in terms of improved efficiency and cost savings.[11]

In an **acquisition**, a corporation or investor group finds a target company and negotiates with its board of directors to purchase it. In Verizon's recent $4.5 billion acquisition of Yahoo, Verizon was the acquirer, and Yahoo the target company.[12]

Worldwide merger activity in the first quarter of 2017 was mixed. The volume of deals was lower but with higher dollar value. The total number of deals fell by 17.9 percent versus the first quarter of 2016; however, the overall deal value was $678.5 billion.[13] We will discuss the increase in international mergers later in this chapter.

Types of Mergers

The three main types of mergers are horizontal, vertical, and conglomerate. In a **horizontal merger**, companies at the same stage in the same industry merge to reduce costs, expand product offerings, or reduce competition. Many of the largest mergers are horizontal mergers to achieve economies of scale. Its $1.25 billion acquisition of trucking company Overnite allowed UPS, the world's largest shipping carrier, to step up expansion of its heavy freight–delivery business, thus expanding its product offerings.[14]

In a **vertical merger**, a company buys a firm in its same industry, often involved in an earlier or later stage of the production or sales process. Buying a supplier of raw materials, a distribution company, or a customer gives the acquiring firm more control. A good example of this is Google's acquisition of Urchin Software Corp., a San Diego–based company that sells web analytics software and services that help companies track the effectiveness of their websites and online advertising. The move enables Google to bolster the software tools it provides to its advertisers.[15]

A **conglomerate merger** brings together companies in unrelated businesses to reduce risk. Combining companies whose products have different seasonal patterns or respond differently to business cycles can result in more stable sales. The Philip Morris Company, now called Altria Group, started out in the tobacco industry but diversified as early as the 1960s with the acquisition of Miller Brewing Company. It diversified into the food industry with its subsequent purchase of General Foods, Kraft Foods, and Nabisco, among others. Later spinning off many businesses, current product categories include cigarettes, smokeless tobacco such as Copenhagen and Skoal, cigars, e-vapor products such as MarkTen, and wines.

A specialized, financially motivated type of merger, the **leveraged buyout (LBO)**became popular in the 1980s but is less common today. LBOs are corporate takeovers financed by large amounts of borrowed money—as much as 90 percent of the purchase price. LBOs can be started by outside investors or the corporation's management. For example, the private equity firm Apollo Global Management LLC agreed to buy U.S. security company ADT Corp. in the largest leveraged buyout (LBO) of 2016.[16]

Often a belief that a company is worth more than the value of all its stock is what drives an LBO. They buy the stock and take the company private, expecting to increase cash flow by improving operating efficiency or selling off units for cash to pay off debt. Although some LBOs do improve efficiency, many do not live up to investor expectations or generate enough cash to pay their debt.

Merger Motives

Although headlines tend to focus on mega-mergers, "merger mania" affects small companies too, and motives for mergers and acquisitions tend to be similar regardless of the company's size. The goal is often strategic: to improve overall performance of the merged firms through cost savings, elimination of overlapping operations, improved purchasing power, increased market share, or

reduced competition. Oracle Corp. paid $5.85 billion to acquire Siebel Systems, its largest competitor in the sales automation programs market.[17]

Company growth, broadening product lines, acquiring technology or management skills, and the ability to quickly acquire new markets are other motives for acquiring a company. Yahoo Inc.'s $1 billion cash purchase of a 40 percent stake in China's biggest e-commerce firm, Alibaba.com, instantly strengthened its ties to the world's second largest internet market.[18]

Purchasing a company can also offer a faster, less risky, less costly option than developing products or markets in-house or expanding internationally. Amazon's 2017 purchase of Whole Foods Market, an upscale grocery chain, for $13.7 billion was a move to enter the retail grocery sector. In addition to the new product market, this move offers Amazon opportunity to sell Amazon tech products in the grocery stores as well as access to an entirely new set of data on consumers.[19]

Another motive for acquisitions is financial restructuring—cutting costs, selling off units, laying off employees, and refinancing the company to increase its value to stockholders. Financially motivated mergers are based not on the potential to achieve economies of scale, but rather on the acquirer's belief that the target has hidden value to be unlocked through restructuring. Most financially motivated mergers involve larger companies. In January 2018, Brookfield Business Partners, a subsidiary of Canada's Brookfield Asset Management, announced that it plans to acquire Westinghouse Electric Co LLC, the bankrupt nuclear services company owned by Toshiba Corp., for $4.6 billion. Brookfield has a history of turning around distressed businesses.[20]

Emerging Truths

Along with the technology boom of the late 1990s, merger activity also soared. Total annual transactions averaged $1.6 trillion a year. Companies were using their stock, which had been pushed to unrealistically high levels, to buy each other. When the technology bubble burst in 2000, the level of merger activity dropped as well. It fell even further after the United States was attacked on September 11, 2001. Then massive corporate wrongdoing began to surface. Stocks plummeted in reaction to these events, and merger transactions, which generally track stock market movements, fell as a result.

Today, merger activity is once again on the rise. Propelled by a solid economy, low interest rates, good credit, rising stock prices, and stockpiles of cash, 2016's $3.84 trillion of global M&A was historically a very strong year, with several blockbuster deals.[21]

Size is definitely an advantage when competing in the global marketplace, but bigger does not always mean better in the merger business. Study results show that heady mega-mergers can, in fact, be a bust for investors who own those shares. So companies are wise to consider their options before stuffing their dollars in the biggest merger slot machine they can find. In their eagerness to snare a deal, many buyers pay a premium that wipes out the merger's entire potential economic gain. Often managers envision grand synergies that prove illusory or unworkable or buy a company that isn't what it seems—not fully understanding what they are getting.

Integrating acquisitions is both an art and a science. Acquirers often underestimate the costs and logistical nightmare of consolidating the operations of merged companies with very different cultures. As a result, they may fail to keep key employees aboard, sales forces selling, and customers happy.

Companies will always continue to seek out acquisition candidates, but the fundamental business case for merging will have to be strong. So what should companies look for to identify mergers with a better-than-even chance of turning out well?

- A purchase price that is low enough—a 10 percent premium over market as opposed to 50 percent—so the buyer doesn't need heroic synergies to make the deal work.
- A target that is significantly smaller than the buyer—and in a business the buyer understands. The more "transformational" the deal, such as entering a new business arena, the bigger the risk.
- A buyer who pays in cash and not overinflated stock.
- Evidence that the deal makes both business and financial sense and isn't purely the brainchild of an empire-building CEO. Mergers are tough—culturally, commercially, and logistically. The most important quality a company can bring to a merger may be humility.

CONCEPT CHECK

1. Differentiate between a merger and an acquisition.
2. What are the most common motives for corporate mergers and acquisitions?

3. Describe the different types of corporate mergers.

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11.8: Trends in Business Ownership

What current trends will affect the business organizations of the future?

As we learned earlier, an awareness of trends in the business environment is critical to business success. Many social, demographic, and economic factors affect how businesses organize. When reviewing options for starting or organizing a business or choosing a career path, consider the following trends.

"Baby Boomers" and "Millennials" Drive Franchise Trends

We all hear and read a great deal about the "graying of America," which refers to the "baby boomer" generation heading toward retirement age. This unprecedented demographic phenomenon—in 2006 the first of 78 million members of the baby boomer generation turned 60—is driving the ongoing battle to stay young, slim, and healthy. Every day, 10,000 boomers are turning 65, and the trend is likely to continue until 2030. Boomers have transformed every life stage they've touched so far, and their demographic weight means that business opportunities are created wherever they go.

With their interest in staying fit, Boomers are contributing to the growth of fitness and weight-loss franchises. In just the past year, this category in *Entrepreneur*'sFranchise 500 has grown to over 50 franchisors. And according to the IHRSA, 52.9 million Americans belong to a health club—up from 39.4 million 10 years ago—so there are plenty of consumers feeding this growing trend.[22]

Another area of boomer-driven franchise growth is eldercare. Founded in 1994, Home Instead Senior Care is recognized as one of the world's fastest growing franchise companies in the eldercare market, with a network of over 1,000 independently owned and operated franchises in 12 countries. And as the world's population continues to age, the need for its unique services will continue to increase.

Home Instead Senior Care provides a meaningful solution for the elderly who prefer to remain at home. Compared with the annual cost for a nursing home placement ($72,000–$92,000), home care at around $45,000–$60,000 a year is somewhat more affordable. Elder quality of life is enhanced by Home Instead Senior Care's part-time, full-time, and around-the-clock services, designed for people who are capable of managing their physical needs but require some assistance and supervision. Home Instead Senior Care provides meal preparation, companionship, light housekeeping, medication reminders, incidental transportation, and errands. These services make it possible for the elderly to remain in the familiar comfort of their own homes for a longer period of time.[23]

But the best deal yet may be adult day services, one of the fastest-growing franchises and "still one of the best-kept secrets around" according to *Entrepreneur*magazine. Based on the concept of day care services for children, Sarah Adult Day Services, Inc. offers a franchising opportunity that meets the two criteria for a successful and socially responsible business: a booming demographic market with great potential for growth, and excellent elder care. Programs such as SarahCare centers are highly affordable for its clients, costing around $17,900 a year. The SarahCare franchise allows entrepreneurs to become part of an expanding industry while restoring a sense of dignity and vibrancy to the lives of older adults.[24]

Millennials—individuals born between 1980 and 2000—are the largest living generation in the United States, according to Pew Research. Millennials spend more money in restaurants per capita than any previous generation. They have been recognized as changing the restaurant scene by looking for brands that offer customized food choices, quality ingredients, freshness, authenticity, transparency, and environmental and social responsibility. According to the U.S. Chamber of Commerce Foundation's report, two out of three millennials are interested in entrepreneurship. According to *Forbes* magazine, 72 percent of millennials would like to be their own boss, 74 percent want flexible work schedules, and 88 percent want "work–life integration." When it comes to owning a franchise, growth potential and meeting a flexible, fulfilling lifestyle are both something that attracts Millennials. A survey by the CT Corporation found that 60 percent of college graduates wanted to start a business after graduation, 67 percent lacked the know-how, 45 percent didn't think they could come up with a name, and 30 percent were not knowledgeable about how to market the business. Franchising is the perfect solution to these issues. For example, Chicago area native and millennial Sal Rehman grew up working in his family's diner. Sal had a dream of operating his own restaurant, and he decided to take the franchising path. In 2015, at the age of 27, Sal opened his first Wing Zone store in suburban Glendale Heights, Illinois. He currently owns five Wing Zones.[25]

Boomers Rewrite the Rules of Retirement

At age 64, Bob Drucker could be the poster child for retirement except that the concept makes him recoil. Drucker is living his dream. He and his wife have a large house on Long Island where Drucker kicks back by floating in his pool when he's not spoiling his granddaughters with trips to Disneyland.

"The only way you can get me out of here is to carry me out," Drucker says, referring to RxUSA, the online pharmacy he founded and runs in Port Washington, New York. "I love my work, and I cannot imagine sitting home and doing nothing."

Drucker is not alone. Today's boomers are working longer at their jobs and embracing postretirement second careers, which often means starting their own small business.[26] As retirees opt to go into business for themselves, they are choosing different forms of business organizations depending on their needs and goals. Some may start small consulting businesses using the simple sole proprietorship form of business organization, while couples or friends might choose to become partners in a retail or franchise venture.

The more healthy and energetic the baby boomer generation remains, the more interested it is in staying active and engaged—and that may mean postponing retirement or not retiring at all. The annual retirement survey by Transamerica Center for Retirement Studies found that as this record number of Americans approaches retirement age, many are not slowing down. In fact, 51 percent of boomers plan to work in some capacity during their retirement years, and 82 percent indicated that they will not retire at or before age 65.[27]

Mergers and Foreign Investment Boom, Too

After shunning big deals for more than three years, corporate America has launched a new merger wave. In 2016, North American companies announced deals totaling almost $2.0 trillion. Many of these deals were large ones, with the largest deal, announced in 2016, AT&T's merger with Time Warner for over $85 billion. In addition, foreign merger activity has reached a new high. Worldwide deal volume in 2015 was 44,000 transactions totaling $4.5 trillion. In 2016, the number of transactions increased to over 48,000, one of the most active periods of merger activity to date. Non-U.S. companies accounted for about two-thirds of the transactions. European companies' cross-border transactions led the way, with deals totaling more than one trillion dollars. The increase is the result of improving economic growth and better stock prices.[28]

This current boom in mergers feels different from earlier merger mania, however. New players are entering the arena, and the number of U.S. and foreign companies making cross-border acquisitions has increased. Whether these new mergers will be good for the global economy remains to be seen. Transactions that lead to cost savings, streamlined operations, and more funding for research and capital investment in new facilities will have positive effects on profitability. Many deals, however, may fail to live up to the acquirers' expectations.

Foreign investment in U.S. companies has also increased dramatically. Annual foreign direct investment reached $373.4 billion in 2016.[29] The jump is the result of a worldwide boom in mergers and acquisitions and the need to finance America's growing trade deficit, as well as the continued attraction of the U.S. economy to investors worldwide.

And what about American investment in foreign economies? It is skyrocketing as U.S. businesses seek out opportunities in developing countries. According to the Congressional Research Service Reports, the outflows from the United States into foreign countries now exceeds $6.4 trillion a year.[30] In addition to the attraction of cheap labor and resources, U.S. companies of all sizes continue to tap the intellectual capital of developing economies such as China and India, outsourcing such functions as payroll, information technology (IT), web/email hosting, customer relationship management (CRM), and human resources (HR) to keep costs under control and enhance profitability.

CONCEPT CHECK

1. What are some of the demographic trends currently impacting American business?
2. As a prospective business owner, what could you do to capitalize on these trends?
3. What other economic trends are influencing today's business organizations?

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CHAPTER OVERVIEW

12: Business Law - Partnerships

Learning Objectives

After reading this chapter, you should understand the following:

- The importance of partnership and the present status of partnership law
- The extent to which a partnership is an entity
- The tests that determine whether a partnership exists
- Partnership by estoppel
- Partnership formation

12.1: Introduction to Partnerships and Entity Theory
12.2: Partnership Formation
12.3: Cases
12.4: Summary and Exercises

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12.1: Introduction to Partnerships and Entity Theory

Learning Objectives

By the end of this section, you will be able to:

- Describe the importance of partnership.
- Understand partnership history.
- Identify the entity characteristics of partnerships.

Importance of Partnership Law

It would be difficult to conceive of a complex society that did not operate its businesses through organizations. In this chapter we study partnerships, limited partnerships, and limited liability companies, and we touch on joint ventures and business trusts.

When two or more people form their own business or professional practice, they usually consider becoming partners. Partnership law defines a partnership as "the association of two or more persons to carry on as co-owners a business for profit…whether or not the persons intend to form a partnership."Revised Uniform Partnership Act, Section 202(a). In 2011, there were more than three million business firms in the United States as partnerships (see Table 18.1, showing data to 2006), and partnerships are a common form of organization among accountants, lawyers, doctors, and other professionals. When we use the word *partnership*, we are referring to the *general business partnership*. There are also limited partnerships and limited liability partnerships, which are discussed in Chapter 20.

Table 12.1.1: Selected Data: Number of US Partnerships, Limited Partnerships, and Limited Liability Companies

	2003	2004	2005	2006
Total number of active partnerships	2,375,375	2,546,877	2,763,625	2,947,116
Number of partners	14,108,458	15,556,553	16,211,908	16,727,803
Number of limited partnerships	378,921	402,238	413,712	432,550
Number of partners	6,262,103	7,023,921	6,946,986	6,738,737
Number of limited liability companies	1,091,502	1,270,236	1,465,223	1,630,161
Number of partners	4,226,099	4,949,808	5,640,146	6,361,958

Source: IRS, http://www.irs.gov/pub/irs-soi/09sprbul.pdf.

Partnerships are also popular as investment vehicles. Partnership law and tax law permit an investor to put capital into a limited partnership and realize tax benefits without liability for the acts of the general partners.

Even if you do not plan to work within a partnership, it can be important to understand the law that governs it. Why? Because it is possible to become someone's partner without intending to or even realizing that a partnership has been created. Knowledge of the law can help you avoid partnership liability.

History of Partnership Law

Through the Twentieth Century

Partnership is an ancient form of business enterprise, and special laws governing partnerships date as far back as 2300 BC, when the Code of Hammurabi explicitly regulated the relations between partners. Partnership was an important part of Roman law, and it played a significant role in the law merchant, the international commercial law of the Middle Ages.

In the nineteenth century, in both England and the United States, partnership was a popular vehicle for business enterprise. But the law governing it was jumbled. Common-law principles were mixed with equitable standards, and the result was considerable confusion. Parliament moved to reduce the uncertainty by adopting the Partnership Act of 1890, but codification took longer in the United States. The Commissioners on Uniform State Laws undertook the task at the turn of the twentieth century. The Uniform Partnership Act (UPA), completed in 1914, and the Uniform Limited Partnership Act (ULPA), completed in 1916, were the basis of partnership law for many decades. UPA and ULPA were adopted by all states except Louisiana.

The Current State of Partnership Law

Despite its name, UPA was not enacted uniformly among the states; moreover, it had some shortcomings. So the states tinkered with it, and by the 1980s, the National Conference of Commissioners on Uniform Laws (NCCUL) determined that a revised version was in order. An amended UPA appeared in 1992, and further amendments were promulgated in 1993, 1994, 1996, and 1997. The NCCUL reports that thirty-nine states have adopted some version of the revised act. This chapter will discuss the Revised Uniform Partnership Act (RUPA) as promulgated in 1997, but because not all jurisdictions have not adopted it, where RUPA makes significant changes, the original 1914 UPA will also be considered.NCCUSL, Uniform Law Commission, "Acts: Partnership Act," www.nccusl.org/Act.aspx?title=Partnership%20Act. The following states *have* adopted the RUPA: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Delaware, District of Columbia, Florida, Hawaii, Idaho, Illinois, Iowa, Kansas, Kentucky, Maine, Maryland, Minnesota, Mississippi, Montana, Nebraska, Nevada, New Jersey, New Mexico, North Dakota, Oklahoma, Oregon, Puerto Rico, South Dakota (substantially similar), Tennessee, Texas (substantially similar), US Virgin Islands, Vermont, Virginia, and Washington. Connecticut, West Virginia, and Wyoming adopted the 1992 or 1994 version. Here are the states that have *not* adopted RUPA (Louisiana never adopted UPA at all): Georgia, Indiana, Massachusetts, Michigan, Mississippi, New Hampshire, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, and Wisconsin. The NCCUL observes in its "prefatory note" to the 1997 act: "The Revised Act is largely a series of 'default rules' that govern the relations among partners in situations they have not addressed in a partnership agreement. The primary focus of RUPA is the small, often informal, partnership. Larger partnerships generally have a partnership agreement addressing, and often modifying, many of the provisions of the partnership act."University of Pennsylvania Law School, Biddle Law Library, "Uniform Partnership Act (1997)," NCCUSL Archives, www.law.upenn.edu/bll/archives/ulc/fnact99/1990s/upa97fa.pdf.

Entity Theory

Meaning of "Legal Entity"

A significant difference between a partnership and most other kinds of business organization relates to whether, and the extent to which, the business is a legal entity. A legal entity is a person or group that the law recognizes as having legal rights, such as the right to own and dispose of property, to sue and be sued, and to enter into contracts; the entity theory is the concept of a business firm as a legal person, with existence and accountability separate from its owners. When individuals carry out a common enterprise as partners, a threshold legal question is whether the partnership is a legal entity. The common law said no. In other words, under the common-law theory, a partnership was but a convenient name for an aggregate of individuals, and the rights and duties recognized and imposed by law are those of the individual partners. By contrast, the mercantile theory of the law merchant held that a partnership is a legal entity that can have rights and duties independent of those of its members.

During the drafting of the 1914 UPA, a debate raged over which theory to adopt. The drafters resolved the debate through a compromise. In Section 6(1), UPA provides a neutral definition of partnership ("an association of two or more persons to carry on as co-owners a business for profit") and retained the common-law theory that a partnership is an aggregation of individuals—the aggregate theory.

RUPA moved more toward making partnerships entities. According to the NCCUL, "The Revised Act enhances the entity treatment of partnerships to achieve simplicity for state law purposes, particularly in matters concerning title to partnership property. RUPA does not, however, relentlessly apply the entity approach. The aggregate approach is retained for some purposes, such as partners' joint and several liability."University of Pennsylvania Law School, Biddle Law Library, "Uniform Partnership Act (1997)," NCCUSL Archives, www.law.upenn.edu/bll/archives/ulc/fnact99/1990s/upa97fa.pdf. Section 201(a) provides, "A partnership is an entity distinct from its partners."RUPA, Section 201(a).

Entity Characteristics of a Partnership

Under RUPA, then, a partnership has entity characteristics, but the partners remain guarantors of partnership obligations, as always—that is the partners' joint and several liability noted in the previous paragraph (and discussed further in Chapter 19). This is a very important point and a primary weakness of the partnership form: all partners are, and each one of them is, ultimately personally liable for the obligations of the partnership, without limit, which includes personal and unlimited liability. This personal liability is very distasteful, and it has been abolished, subject to some exceptions, with limited partnerships and limited liability companies, as discussed in Chapter 20. And, of course, the owners of corporations are also not generally liable for the corporation's obligations, which is a major reason for the corporate form's popularity.

For Accounting Purposes

Under both versions of the law, the partnership may keep business records as if it were a separate entity, and its accountants may treat it as such for purposes of preparing income statements and balance sheets.

For Purposes of Taxation

Under both versions of the law, partnerships are *not* taxable entities, so they do not pay income taxes. Instead, each partner's distributive share, which includes income or other gain, loss, deductions, and credits, must be included in the partner's personal income tax return, whether or not the share is actually distributed.

For Purposes of Litigation

In litigation, the aggregate theory causes some inconvenience in naming and serving partnership defendants: under UPA, lawsuits to enforce a partnership contract or some other right must be filed in the name of all the partners. Similarly, to sue a partnership, the plaintiff must name and sue each of the partners. This cumbersome procedure was modified in many states, which enacted special statutes expressly permitting suits by and against partnerships in the firm name. In suits on a claim in federal court, a partnership may sue and be sued in its common name. The move by RUPA to make partnerships entities changed very little. Certainly it provides that "a partnership may sue and be sued in the name of the partnership"—that's handy where the plaintiff hopes for a judgment against the partnership, without recourse to the individual partners' personal assets.RUPA, Section 307(a). But a plaintiff must still name the partnership and the partners individually to have access to both estates, the partnership and the individuals': "A judgment against a partnership is not by itself a judgment against a partner. A judgment against a partnership may not be satisfied from a partner's assets unless there is also a judgment against the partner."RUPA, Section 307(c).

For Purposes of Owning Real Estate

Aggregate theory concepts bedeviled property co-ownership issues, so UPA finessed the issue by stating that partnership property, real or personal, could be held in the name of the partners as "tenants in partnership"—a type of co-ownership—or it could be held in the name of the partnership.Uniform Partnership Act, Section 25(1); UPA, Section 8(3). Under RUPA, "property acquired by the partnership is property of the partnership and not of the partners."RUPA, Section 203. But RUPA is no different from UPA in practical effect. The latter provides that "property originally brought into the partnership stock or subsequently acquired by purchase…on account of the partnership, is partnership property."UPA, Section 8(1). Under either law, a partner may bring onto the partnership premises her own property, not acquired in the name of the partnership or with its credit, and it remains her separate property. Under neither law can a partner unilaterally dispose of partnership property, however labeled, for the obvious reason that one cannot dispose of another's property or property rights without permission.UPA, Sections 9(3)(a) and 25; RUPA, Section 302. And keep in mind that partnership law is the default: partners are free to make up partnership agreements as they like, subject to some limitations. They are free to set up property ownership rules as they like.

For Purposes of Bankruptcy

Under federal bankruptcy law—state partnership law is preempted—a partnership is an entity that may voluntarily seek the haven of a bankruptcy court or that may involuntarily be thrust into a bankruptcy proceeding by its creditors. The partnership cannot discharge its debts in a liquidation proceeding under Chapter 7 of the bankruptcy law, but it can be rehabilitated under Chapter 11 (see Chapter 13).

Key Takeaway

Partnership law is very important because it is the way most small businesses are organized and because it is possible for a person to become a partner without intending to. Partnership law goes back a long way, but in the United States, most states—but not all—have adopted the Revised Uniform Partnership Act (RUPA, 1997) over the previous Uniform Partnership Act, originally promulgated in 1914. One salient change made by RUPA is to directly announce that a partnership is an entity: it is like a person for purposes of accounting, litigation, bankruptcy, and owning real estate. Partnerships do not pay taxes; the individual partners do. But in practical terms, what RUPA does is codify already-existing state law on these matters, and partners are free to organize their relationship as they like in the partnership agreement.

Exercises

1. When was UPA set out for states to adopt? When was RUPA promulgated for state adoption?
2. What does it mean to say that the partnership act is the “default position”? For what types of partnership is UPA (or RUPA) likely to be of most importance?
3. What is the aggregate theory of partnership? The entity theory?

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12.2: Partnership Formation

Learning Objectives

By the end of this section, you will be able to:

- Describe the creation of an express partnership.
- Describe the creation of an implied partnership.
- Identify tests of partnership existence.
- Understand partnership by estoppel.

Creation of an Express Partnership

Creation in General

The most common way of forming a partnership is expressly—that is, in words, orally or in writing. Such a partnership is called an express partnership. If parties have an express partnership with no partnership agreement, the relevant law—the Uniform Partnership Act (UPA) or the Revised Uniform Partnership Act (RUPA)—applies the governing rules.

Assume that three persons have decided to form a partnership to run a car dealership. Able contributes $250,000. Baker contributes the building and space in which the business will operate. Carr contributes his services; he will manage the dealership.

The first question is whether Able, Baker, and Carr must have a partnership agreement. As should be clear from the foregoing discussion, no agreement is necessary as long as the tests of partnership are met. However, they *ought* to have an agreement in order to spell out their rights and duties among themselves.

The agreement itself is a contract and should follow the principles and rules spelled out in Chapter 8 of this book. Because it is intended to govern the relations of the partners toward themselves and their business, every partnership contract should set forth clearly the following terms: (1) the name under which the partners will do business; (2) the names of the partners; (3) the nature, scope, and location of the business; (4) the capital contributions of each partner; (5) how profits and losses are to be divided; (6) how salaries, if any, are to be determined; (7) the responsibilities of each partner for managing the business; (8) limitations on the power of each partner to bind the firm; (9) the method by which a given partner may withdraw from the partnership; (10) continuation of the firm in the event of a partner's death and the formula for paying a partnership interest to his heirs; and (11) method of dissolution.

Specific Issues of Concern

In forming a partnership, three of these items merit special attention. And note again that if the parties do not provide for these in their agreement, RUPA will do it for them as the default.

Who Can Be a Partner?

As discussed earlier in this chapter, a partnership is not limited to a direct association between human beings but may also include an association between other entities, such as corporations or even partnerships themselves.A **joint venture**—sometimes known as a joint adventure, coadventure, joint enterprise, joint undertaking, syndicate, group, or pool—is an association of persons to carry on a particular task until completed. In essence, a joint venture is a "temporary partnership." In the United States, the use of joint ventures began with the railroads in the late 1800s. Throughout the middle part of the twentieth century joint ventures were common in the manufacturing sector. By the late 1980s, they increasingly appeared in both manufacturing and service industries as businesses looked for new, competitive strategies. They are aggressively promoted on the Internet: "Joint Ventures are in, and if you're not utilizing this strategic weapon, chances are your competition is, or will soon be, using this to their advantage.…possibly against you!" (Scott Allen, "Joint Venturing 101," About.com Entrepreneurs, http://entrepreneurs.about.com/od/beyondstartup/a/jointventures.htm).As a risk-avoiding device, the joint venture allows two or more firms to pool their differing expertise so that neither needs to "learn the ropes" from the beginning; neither needs the entire capital to start the enterprise.Partnership rules generally apply, although the relationship of the joint venturers is closer to that of special than general agency as discussed in Chapter 14. Joint venturers are fiduciaries toward one another. Although no formality is

necessary, the associates will usually sign an agreement. The joint venture need have no group name, though it may have one. Property may be owned jointly. Profits and losses will be shared, as in a partnership, and each associate has the right to participate in management. Liability is unlimited.Sometimes two or more businesses will form a joint venture to carry out a specific task—prospecting for oil, building a nuclear reactor, doing basic scientific research—and will incorporate the joint venture. In that case, the resulting business—known as a "joint venture corporation"—is governed by corporation law, not the law of partnership, and is not a joint venture in the sense described here. Increasingly, companies are forming joint ventures to do business abroad; foreign investors or governments own significant interests in these joint ventures. For example, in 1984 General Motors entered into a joint venture with Toyota to revive GM's shuttered Fremont, California, assembly plant to create New United Motor Manufacturing, Inc. (NUMMI). For GM the joint venture was an opportunity to learn about lean manufacturing from the Japanese company, while Toyota gained its first manufacturing base in North America and a chance to test its production system in an American labor environment. Until May 2010, when the copartnership ended and the plant closed, NUMMI built an average of six thousand vehicles a week, or nearly eight million cars and trucks. These vehicles were the Chevrolet Nova (1984–88), the Geo Prizm (1989–97), the Chevrolet Prizm (1998–2002), and the Hilux (1991–95, predecessor of the Tacoma), as well as the Toyota Voltz, the Japanese right-hand-drive version of the Pontiac Vibe. The latter two were based on the Toyota Matrix. Paul Stenquist, "GM and Toyota's Joint Venture Ends in California," *New York Times*, April 2, 2010, wheels.blogs.nytimes.com/2010/04/02/g-m-and-toyotas-joint-venture-ends-in-california. Family members can be partners, and partnerships between parents and minor children are lawful, although a partner who is a minor may disaffirm the agreement.

Written versus Oral Agreements

If the business cannot be performed within one year from the time that the agreement is entered into, the partnership agreement should be in writing to avoid invalidation under the Statute of Frauds. Most partnerships have no fixed term, however, and are partnerships "at will" and therefore not covered by the Statute of Frauds.

Validity of the Partnership Name

Able, Baker, and Carr decide that it makes good business sense to choose an imposing, catchy, and well-known name for their dealership—General Motors Corporation. There are two reasons why they cannot do so. First, their business is a partnership, not a corporation, and should not be described as one. Second, the name is deceptive because it is the name of an existing business. Furthermore, if not registered, the name would violate the assumed or fictitious name statutes of most states. These require that anyone doing business under a name other than his real name register the name, together with the names and addresses of the proprietors, in some public office. (Often, the statutes require the proprietors to publish this information in the newspapers when the business is started.) As *Loomis v. Whitehead* in Section 18.3.2 "Creation of a Partnership: Registering the Name" shows, if a business fails to comply with the statute, it could find that it will be unable to file suit to enforce its contracts.

Creation of Implied Partnership

An implied partnership exists when in fact there are two or more persons carrying on a business as co-owners for profit. For example, Carlos decides to paint houses during his summer break. He gathers some materials and gets several jobs. He hires Wally as a helper. Wally is very good, and pretty soon both of them are deciding what jobs to do and how much to charge, and they are splitting the profits. They have an implied partnership, without intending to create a partnership at all.

Tests of Partnership Existence

But how do we know whether an implied partnership *has* been created? Obviously, we know if there is an express agreement. But partnerships can come into existence quite informally, indeed, without any formality—they can be created accidentally. In contrast to the corporation, which is the creature of statute, partnership is a catchall term for a large variety of working relationships, and frequently, uncertainties arise about whether or not a particular relationship is that of partnership. The law can reduce the uncertainty in advance only at the price of severely restricting the flexibility of people to associate. As the chief drafter of the Uniform Partnership Act (UPA, 1914) explained,

All other business associations are statutory in origin. They are formed by the happening of an event designated in a statute as necessary to their formation. In corporations this act may be the issuing of a charter by the proper officer of the state; in limited partnerships, the filing by the associates of a specified document in a public office. On the other hand, an infinite number of combinations of circumstances may result in co-ownership of a business. Partnership is the residuum, including all forms of co-

ownership, of a business except those business associations organized under a specific statute.W. D. Lewis, “The Uniform Partnership Act,” *Yale Law Journal* 24 (1915): 617, 622.



Figure 18.1 Partnership Tests

Because it is frequently important to know whether a partnership exists (as when a creditor has dealt with only one party but wishes to also hold others liable by claiming they were partners, see Section 18.3.1 “Tests of Partnership Existence”, *Chaiken v. Employment Security Commission*), a number of tests have been established that are clues to the existence of a partnership (see Figure 18.1). We return to the definition of a partnership: “the association of two or more persons to carry on as co-owners a business for profit[.]” The three elements are (1) the association of persons, (2) as co-owners, (3) for profit.

Association of Persons

This element is pretty obvious. A partnership is a contractual agreement among persons, so the persons involved need to have *capacity* to contract. But RUPA does not provide that only *natural* persons can be partners; it defines *person* as follows: “‘Person’ means an individual, corporation, business trust, estate, trust, partnership, association, joint venture, government, governmental subdivision, agency, or instrumentality, or any other legal or commercial entity.”RUPA, Section 101(10). Thus unless state law precludes it, a corporation can be a partner in a partnership. The same is true under UPA.

Co-owners of a Business

If what two or more people own is clearly a business—including capital assets, contracts with employees or agents, an income stream, and debts incurred on behalf of the operation—a partnership exists. A tougher question arises when two or more persons co-own property. Do they automatically become partners? The answer can be important: if one of the owners while doing business pertinent to the property injures a stranger, the latter could sue the other owners if there is a partnership.

Co-ownership comes in many guises. The four most common are joint tenancy, tenancy in common, tenancy by the entireties, and community property. In joint tenancy, the owners hold the property under a single instrument, such as a deed, and if one dies, the others automatically become owners of the deceased’s share, which does not descend to his heirs. Tenancy in common has the reverse rule: the survivor tenants do not take the deceased’s share. Each tenant in common has a distinct estate in the property. The tenancy by the entirety and community property (in community-property states) forms of ownership are limited to spouses, and their effects are similar to that of joint tenancy. These concepts are discussed in more detail in relation to real property in Chapter 31.

Suppose a husband and wife who own their home as tenants by the entirety (or community property) decide to spend the summer at the seashore and rent their home for three months. Is their co-ownership sufficient to establish that they are partners? The answer is no. By UPA Section 7(2) and RUPA Section 202(b)(1), the various forms of joint ownership by themselves do not establish partnership, whether or not the co-owners share profits made by the use of the property. To establish a partnership, the ownership must be of a business, not merely of property.

Sharing of Profits

There are two aspects to consider with regard to profits: first, whether the business is for-profit, and second, whether there is a sharing of the profit.

Business for Profit

Unincorporated nonprofit organizations (UNAs) cannot be partnerships. The paucity of coherent law governing these organizations gave rise in 2005 to the National Conference of Commissioners of Uniform Laws’ promulgation of the Revised Uniform

Unincorporated Nonprofit Association Act (RUUNAA). The prefatory note to this act says, "RUUNAA was drafted with small informal associations in mind. These informal organizations are likely to have no legal advice and so fail to consider legal and organizational questions, including whether to incorporate. The act provides better answers than the common law for a limited number of legal problems…There are probably hundreds of thousands of UNAs in the United States including unincorporated nonprofit philanthropic, educational, scientific and literary clubs, sporting organizations, unions, trade associations, political organizations, churches, hospitals, and condominium and neighborhood associations."Revised Uniform Unincorporated Nonprofit Associations Act, www.abanet.org/intlaw/leadership/policy/RUUNAA_Final_08.pdf. At least twelve states have adopted RUUNAA or its predecessor.

Sharing the Profit

While co-ownership does not establish a partnership unless there is a business, a business by itself is not a partnership unless co-ownership is present. Of the tests used by courts to determine co-ownership, perhaps the most important is sharing of profits. Section 202(c) of RUPA provides that "a person who receives a share of the profits of a business is presumed to be a partner in the business," but this presumption can be rebutted by showing that the share of the profits paid out was (1) to repay a debt; (2) wages or compensation to an independent contractor; (3) rent; (4) an annuity, retirement, or health benefit to a representative of a deceased or retired partner; (5) interest on a loan, or rights to income, proceeds, or increase in value from collateral; or (5) for the sale of the goodwill of a business or other property. Section 7(4) of UPA is to the same effect.

Other Factors

Courts are not limited to the profit-sharing test; they also look at these factors, among others: the right to participate in decision making, the duty to share liabilities, and the manner in which the business is operated. Section 18.3.1 "Tests of Partnership Existence", *Chaiken v. Employment Security Commission*, illustrates how these factors are weighed in court.

Creation of Partnership by Estoppel

Ordinarily, if two people are not legally partners, then third parties cannot so regard them. For example, Mr. Tot and Mr. Tut own equal shares of a house that they rent but do not regard it as a business and are not in fact partners. They do have a loose "understanding" that since Mr. Tot is mechanically adept, he will make necessary repairs whenever the tenants call. On his way to the house one day to fix its boiler, Mr. Tot injures a pedestrian, who sues both Mr. Tot and Mr. Tut. Since they are not partners, the pedestrian cannot sue them as if they were; hence Mr. Tut has no partnership liability.

Suppose that Mr. Tot and Mr. Tut happened to go to a lumberyard together to purchase materials that Mr. Tot intended to use to add a room to the house. Short of cash, Mr. Tot looks around and espies Mr. Tat, who greets his two friends heartily by saying within earshot of the salesman who is debating whether to extend credit, "Well, how are my two partners this morning?" Messrs. Tot and Tut say nothing but smile faintly at the salesman, who mistakenly but reasonably believes that the two are acknowledging the partnership. The salesman knows Mr. Tat well and assumes that since Mr. Tat is rich, extending credit to the "partnership" is a "sure thing." Messrs. Tot and Tut fail to pay. The lumberyard is entitled to collect from Mr. Tat, even though he may have forgotten completely about the incident by the time suit is filed. Under Uniform Partnership Act Section 16(1), Mr. Tat would be liable for the debt as being part of a partnership by estoppel. The Revised Uniform Partnership Act is to the same effect:

Section 308. Liability of Purported Partner.

(a) If a person, by words or conduct, purports to be a partner, or consents to being represented by another as a partner, in a partnership or with one or more persons not partners, the purported partner is liable to a person to whom the representation is made, if that person, relying on the representation, enters into a transaction with the actual or purported partnership.

Partnership by estoppel has two elements: (1) a representation to a third party that there is in fact a partnership and (2) reliance by the third party on the representation. See Section 18.3.3 "Partnership by Estoppel", *Chavers v. Epsco, Inc.*, for an example of partnership by estoppel.

Key Takeaway

A partnership is any two or more persons—including corporate persons—carrying on a business as co-owners for profit. A primary test of whether a partnership exists is whether there is a sharing of profits, though other factors such as sharing decision making, sharing liabilities, and how the business is operated are also examined.

Most partnerships are expressly created. Several factors become important in the partnership agreement, whether written or oral. These include the name of the business, the capital contributions of each partner, profit sharing, and decision making. But a partnership can also arise by implication or by estoppel, where one has held herself as a partner and another has relied on that representation.

Exercises

1. Why is it necessary—or at least useful—to have tests to determine whether a partnership exists?
2. What elements of the business organization are examined to make this determination?
3. Jacob rents farmland from Davis and pays Davis a part of the profits from the crop in rent. Is Davis a partner? What if Davis offers suggestions on what to plant and when? Now is he a partner?
4. What elements should be included in a written partnership agreement?
5. What is an implied partnership?
6. What is a partnership by estoppel, and why are its “partners” estopped to deny its existence?

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12.3: Cases

Tests of Partnership Existence

Chaiken v. Employment Security Commission

274 A.2d 707 (Del. 1971)

STOREY, J.

The Employment Security Commission, hereinafter referred to as the Commission, levied an involuntary assessment against Richard K. Chaiken, complainant, hereinafter referred to as Chaiken, for not filing his unemployment security assessment report. Pursuant to the same statutory section, a hearing was held and a determination made by the Commission that Chaiken was the employer of two barbers in his barber shop and that he should be assessed as an employer for his share of unemployment compensation contributions. Chaiken appealed the Commission's decision.…

Both in the administrative hearing and in his appeal brief Chaiken argues that he had entered into partnership agreements with each of his barbers and, therefore, was and is not subject to unemployment compensation assessment. The burden is upon the individual assessed to show that he is outside the ambit of the statutory sections requiring assessment. If Chaiken's partnership argument fails he has no secondary position and he fails to meet his burden.

Chaiken contends that he and his "partners":

1. properly registered the partnership name and names of partners in the prothonotary's office, in accordance with [the relevant statute],The word *prothonotary* means first notary of the court. The prothonotary is the keeper of the civil records for the court system. The office is responsible for the creation, maintenance, and certification of matters pending or determined by the court. The office is also responsible for certain reporting and collection duties to state agencies.
2. properly filed federal partnership information returns and paid federal taxes quarterly on an estimated basis, and
3. duly executed partnership agreements.

Of the three factors, the last is most important. Agreements of "partnership" were executed between Chaiken and Mr. Strazella, a barber in the shop, and between Chaiken and Mr. Spitzer, similarly situated. The agreements were nearly identical. The first paragraph declared the creation of a partnership and the location of business. The second provided that Chaiken would provide barber chair, supplies, and licenses, while the other partner would provide tools of the trade. The paragraph also declared that upon dissolution of the partnership, ownership of items would revert to the party providing them. The third paragraph declared that the income of the partnership would be divided 30% for Chaiken, 70% for Strazella; 20% for Chaiken and 80% for Spitzer. The fourth paragraph declared that all partnership policy would be decided by Chaiken, whose decision was final. The fifth paragraph forbade assignment of the agreement without permission of Chaiken. The sixth paragraph required Chaiken to hold and distribute all receipts. The final paragraph stated hours of work for Strazella and Spitzer and holidays.

The mere existence of an agreement labeled "partnership" agreement and the characterization of signatories as "partners" docs not conclusively prove the existence of a partnership. Rather, the intention of the parties, as explained by the wording of the agreement, is paramount.

A partnership is defined as an association of two or more persons to carry on as co-owners a business for profit. As co-owners of a business, partners have an equal right in the decision making process. But this right may be abrogated by agreement of the parties without destroying the partnership concept, provided other partnership elements are present.

Thus, while paragraph four reserves for Chaiken all right to determine partnership policy, it is not standing alone, fatal to the partnership concept. Co-owners should also contribute valuable consideration for the creation of the business. Under paragraph two, however, Chaiken provides the barber chair (and implicitly the barber shop itself), mirror, licenses and linen, while the other partners merely provide their tools and labor—nothing more than any barber-employee would furnish. Standing alone, however, mere contribution of work and skill can be valuable consideration for a partnership agreement.

Partnership interests may be assignable, although it is not a violation of partnership law to prohibit assignment in a partnership agreement. Therefore, paragraph five on assignment of partnership interests does not violate the partnership concept. On the other hand, distribution of partnership assets to the partners upon dissolution is only allowed after all partnership liabilities are satisfied.

But paragraph two of the agreement, in stating the ground rules for dissolution, makes no declaration that the partnership assets will be utilized to pay partnership expenses before reversion to their original owners. This deficiency militates against a finding in favor of partnership intent since it is assumed Chaiken would have inserted such provision had he thought his lesser partners would accept such liability. Partners do accept such liability, employees do not.

Most importantly, co-owners carry on "a business for profit." The phrase has been interpreted to mean that partners share in the profits and the losses of the business. The intent to divide the profits is an indispensable requisite of partnership. Paragraph three of the agreement declares that each partner shall share in the income of the business. There is no sharing of the profits, and as the agreement is drafted, there are no profits. Merely sharing the gross returns does not establish a partnership. Nor is the sharing of profits prima facie evidence of a partnership where the profits received are in payment of wages.

The failure to share profits, therefore, is fatal to the partnership concept here.

Evaluating Chaiken's agreement in light of the elements implicit in a partnership, no partnership intent can be found. The absence of the important right of decision making or the important duty to share liabilities upon dissolution individually may not be fatal to a partnership. But when both are absent, coupled with the absence of profit sharing, they become strong factors in discrediting the partnership argument. Such weighing of the elements against a partnership finding compares favorably with *Fenwick v. Unemployment Compensation Commission*, which decided against the partnership theory on similar facts, including the filing of partnership income tax forms.

In addition, the total circumstances of the case taken together indicate the employer-employee relationship between Chaiken and his barbers. The agreement set forth the hours of work and days off—unusual subjects for partnership agreements. The barbers brought into the relationship only the equipment required of all barber shop operators. And each barber had his own individual "partnership" with Chaiken. Furthermore, Chaiken conducted all transactions with suppliers, and purchased licenses, insurance, and the lease for the business property in his own name. Finally, the name "Richard's Barber Shop" continued to be used after the execution of the so-called partnership agreements. [The Commission's decision is affirmed.]

? Case Questions

1. Why did the unemployment board sue Chaiken?
2. Why did Chaiken set up this "partnership"?
3. What factors did the court examine to determine whether there was a partnership here? Which one was the most important?
4. Why would it be unusual in a partnership agreement to set forth the hours of work and days off?

Creation of a Partnership: Registering the Name

Loomis v. Whitehead

183 P.3d 890 (Nev. 2008)

Per Curiam.

In this appeal, we address whether [Nevada Revised Statute] NRS 602.070 bars the partners of an unregistered fictitious name partnership from bringing an action arising out of a business agreement that was not made under the fictitious name. [The statute] prohibits persons who fail to file an assumed or fictitious name certificate from suing on any contract or agreement made under the assumed or fictitious name. We conclude that it does not bar the partners from bringing the action so long as the partners did not conduct the business or enter into an agreement under the fictitious name or otherwise mislead the other party into thinking that he was doing business with some entity other than the partners themselves.

Background Facts

Appellants Leroy Loomis and David R. Shanahan raised and sold cattle in Elko County, Nevada. Each of the appellants had certain responsibilities relating to the cattle business. Loomis supplied the livestock and paid expenses, while Shanahan managed the day-to-day care of the cattle. Once the cattle were readied for market and sold, Loomis and Shanahan would share the profits equally. While Loomis and Shanahan often called themselves the 52 Cattle Company, they had no formal partnership agreement and did not file an assumed or fictitious name certificate in that name. Loomis and Shanahan bring this appeal after an agreement entered into with respondent Jerry Carr Whitehead failed.

In the fall of 2003, Shanahan entered into a verbal agreement with Whitehead, a rancher, through Whitehead's ranch foreman to have their cattle wintered at Whitehead's ranch. Neither Loomis nor Whitehead was present when the ranch foreman made the deal with Shanahan, but the parties agree that there was no mention of the 52 Cattle Company at the time they entered into the agreement or anytime during the course of business thereafter. Shanahan and Loomis subsequently alleged that their cattle were malnourished and that a number of their cattle died from starvation that winter at Whitehead's ranch. Whitehead denied these allegations.

Suit against Whitehead

The following summer, Shanahan and Loomis sued Whitehead, claiming negligence and breach of contract. Later, well into discovery, Whitehead was made aware of the existence of the 52 Cattle Company when Shanahan stated in his deposition that he did not actually own any of the cattle on Whitehead's ranch. In his deposition, he described the partnership arrangement. At about the same time, Whitehead learned that the name "52 Cattle Company" was not registered with the Elko County Clerk.

Whitehead then filed a motion for partial summary judgment, asserting that, pursuant to NRS 602.070, Loomis and Shanahan's failure to register their fictitiously named partnership with the county clerk barred them from bringing a legal action. The district court agreed with Whitehead, granted the motion, and dismissed Loomis and Shanahan's claims. Loomis and Shanahan timely appealed.

Discussion

The district court found that Loomis and Shanahan conducted business under a fictitious name without filing a fictitious name certificate with the Elko County Clerk as required by NRS 602.010.NRS 602.010(1): "Every person doing business in this state under an assumed or fictitious name that is in any way different from the legal name of each person who owns an interest in the business must file with the county clerk of each county in which the business is being conducted a certificate containing the information required by NRS 602.020." The district court therefore concluded that, pursuant to NRS 602.070, they were barred from bringing an action against Whitehead because they did not file a fictitious name certificate for the 52 Cattle Company.NRS 602.070: "No action may be commenced or maintained by any person…upon or on account of any contract made or transaction had under the assumed or fictitious name, or upon or on account of any cause of action arising or growing out of the business conducted under that name, unless before the commencement of the action the certificate required by NRS 602.010 has been filed."

Loomis and Shanahan contend that the district court erred in granting partial summary judgment because they did not enter into a contract with Whitehead under the name of the 52 Cattle Company, and they did not conduct business with Whitehead under that name. Loomis and Shanahan argue that NRS 602.070 is not applicable to their action against Whitehead because they did not mislead Whitehead into thinking that he was doing business with anyone other than them. We agree.…

When looking at a statute's language, this court is bound to follow the statute's plain meaning, unless the plain meaning was clearly not intended. Here, in using the phrase "under the assumed or fictitious name," the statute clearly bars bringing an action when the claims arise from a contract, transaction, or business conducted beneath the banner of an unregistered fictitious name. However, NRS 602.070 does not apply to individual partners whose transactions or business with another party were not performed under the fictitious name.

Here, Whitehead knew that Shanahan entered into the oral contract under his own name. He initially thought that Shanahan owned the cattle and Loomis had "some type of interest." Shanahan did not enter into the contract under the fictitious "52 Cattle Company" name. Moreover, Whitehead does not allege that he was misled by either Loomis or Shanahan in any way that would cause him to think he was doing business with the 52 Cattle Company. In fact, Whitehead did not know of the 52 Cattle Company until Shanahan mentioned it in his deposition. Under these circumstances, when there simply was no indication that Loomis and Shanahan represented that they were conducting business as the 52 Cattle Company and no reliance by Whitehead that he was doing business with the 52 Cattle Company, NRS 602.070 does not bar the suit against Whitehead.

We therefore reverse the district court's partial summary judgment in this instance and remand for trial because, while the lawsuit between Loomis and Whitehead involved partnership business, the transaction at issue was not conducted and the subsequent suit was not maintained under the aegis of the fictitiously named partnership.

Case Questions

1. The purpose of the fictitious name statute might well be, as the court here describes it, "to prevent fraud and to give the public information about those entities with which they conduct business." But that's not what the statute says; it says nobody can sue on a cause of action arising out of business conducted under a fictitious name if the name is not registered. The legislature determined the consequence of failure to register. Should the court disregard the statute's plain, unambiguous meaning?
2. That was one of two arguments by the dissent in this case. The second one was based on this problem: Shanahan and Loomis agreed that the cattle at issue were partnership cattle bearing the "52" brand. That is, the cows were *not* Shanahan's; they were the partnership's. When Whitehead moved to dismiss Shanahan's claim—again, because the cows weren't Shanahan's—Shanahan conceded that but for the existence of the partnership he would have no claim against Whitehead. If there is no claim against the defendant except insofar as he harmed the partnership business (the cattle), how could the majority assert that claims against Whitehead did not arise out of "the business" conducted under 52 Cattle Company? Who has the better argument, the majority or the dissent?
3. Here is another problem along the same lines but with a different set of facts and a Uniform Partnership Act (UPA) jurisdiction (i.e., pre–Revised Uniform Partnership Act [RUPA]). Suppose the plaintiffs had a partnership (as they did here), but the claim by one was that the other partner had stolen several head of cattle, and UPA was in effect so that the partnership property was owned as "tenant in partnership"—the cattle would be owned by the partners as a whole. A person who steals his own property cannot be criminally liable; therefore, a partner cannot be guilty of stealing (or misappropriating) firm property. Thus under UPA there arise anomalous cases, for example, in *People v. Zinke*, 555 N.E.2d 263 (N.Y. 1990), which is a criminal case, Zinke embezzled over a million dollars from his own investment firm but the prosecutor's case against him was dismissed because, the New York court said, "partners cannot be prosecuted for stealing firm property." If the partnership is a legal entity, as under RUPA, how is this result changed?

Partnership by Estoppel

Chavers v. Epsco, Inc.

98 S.W.3d 421 (Ark. 2003)

Hannah, J.

Appellants Reggie Chavers and Mark Chavers appeal a judgment entered against them by the Craighead County Circuit Court. Reggie and Mark argue that the trial court erred in holding them liable for a company debt based upon partnership by estoppel because the proof was vague and insufficient and there was no detrimental reliance on the part of a creditor. We hold that the trial court was not clearly erroneous in finding liability based upon partnership by estoppel. Accordingly, we affirm.

Facts

Gary Chavers operated Chavers Welding and Construction ("CWC"), a construction and welding business, in Jonesboro. Gary's sons Reggie Chavers and Mark Chavers joined their father in the business after graduating from high school. Gary, Mark, and Reggie maintain that CWC was a sole proprietorship owned by Gary, and that Reggie and Mark served only as CWC employees, not as CWC partners.

In February 1999, CWC entered into an agreement with Epsco, Inc. ("Epsco"), a staffing service, to provide payroll and employee services for CWC. Initially, Epsco collected payments for its services on a weekly basis, but later, Epsco extended credit to CWC. Melton Clegg, President of Epsco, stated that his decision to extend credit to CWC was based, in part, on his belief that CWC was a partnership.

CWC's account with Epsco became delinquent, and Epsco filed a complaint against Gary, Reggie, and Mark, individually, and doing business as CWC, to recover payment for the past due account. Gary discharged a portion of his obligation to Epsco due to his filing for bankruptcy. Epsco sought to recover CWC's remaining debt from Reggie and Mark. After a hearing on March 7, 2002, the trial court issued a letter opinion, finding that Reggie and Mark "represented themselves to [Epsco] as partners in an existing partnership and operated in such a fashion to give creditors in general, and Epsco in particular, the impression that such creditors/potential creditors were doing business with a partnership.…" On May 21, 2002, the trial court entered an order stating

that Reggie and Mark were partners by estoppel as relates to Epsco. The trial court found that Reggie and Mark were jointly and severally liable for the debt of CWC in the amount of $80,360.92. In addition, the trial court awarded Epsco pre-judgment interest at the rate of six percent, post-judgment interest at the rate of ten percent, and attorney's fees in the amount of $8,036.92.

[The relevant Arkansas statute provides]:

(1) When a person, by words spoken or written or by conduct, represents himself, or consents to another representing him to any one, as a partner in an existing partnership or with one (1) or more persons not actual partners, he is liable to any person to whom such representation has been made, who has, on the faith of such representation, given credit to the actual or apparent partnership, and if he has made such representation or consented to its being made in a public manner, he is liable to that person, whether the representation has or has not been made or communicated to that person so giving credit by or with the knowledge of the apparent partner making the representation or consenting to it being made.

(a) When a partnership liability results, he is liable as though he were an actual member of the partnership.

We have long recognized the doctrine of partnership by estoppel. [Citation, 1840], the court stated that

they who hold themselves out to the world as partners in business or trade, are to be so regarded as to creditors and third persons; and the partnership may be established by any evidence showing that they so hold themselves out to the public, and were so regarded by the trading community.

Further, we have stated that "[p]artnerships may be proved by circumstantial evidence; and evidence will sometimes fix a joint liability, where persons are charged as partners, in a suit by a third person, when they are not, in fact, partners as between themselves." [Citation, 1843.]

In [Citation, 1906], the court noted that

[a] person who holds himself out as a partner of a firm is estopped to deny such representation, not only as to those as to whom the representation was directly made, but as to all others who had knowledge of such holding out and in reliance thereon sold goods to the firm.…

In addition, "if the party himself puts out the report that he is a partner, he will be liable to all those selling goods to the firm on the faith and credit of such report." [Citation] When a person holds himself out as a member of partnership, any one dealing with the firm on the faith of such representation is entitled to assume the relation continues until notice of some kind is given of its discontinuance. [Citations]

In [Citation, 1944], the court wrote:

It is a thoroughly well-settled rule that persons who are not as between themselves partners, or as between whom there is in fact no legal partnership, may nevertheless become subject to the liabilities of partners, either by holding themselves out as partners to the public and the world generally or to particular individuals, or by knowingly or negligently permitting another person to do so. All persons who hold themselves out, or knowingly permit others to hold them out, to the public as partners, although they are not in partnership, become bound as partners to all who deal with them in their apparent relation.

The liability as a partner of a person who holds himself out as a partner, or permits others to do so, is predicated on the doctrine of estoppel and on the policy of the law seeking to prevent frauds on those who lend their money on the apparent credit of those who are held out as partners. One holding himself out as a partner or knowingly permitting himself to be so held out is estopped from denying liability as a partner to one who has extended credit in reliance thereon, although no partnership has in fact existed.

In the present case, the trial court cited specific examples of representations made by Reggie and Mark indicating that they were partners of CWC, including correspondence to Epsco, checks written to Epsco, business cards distributed to the public, and credit applications. We will discuss each in turn.

The Faxed Credit References

Epsco argues that Plaintiff's Exhibit # 1, a faxed list of credit references, clearly indicates that Gary was the owner and that Reggie and Mark were partners in the business. The fax lists four credit references, and it includes CWC's contact information. The contact information lists CWC's telephone number, fax number, and federal tax number. The last two lines of the contact information state: "Gary Chavers Owner" and "Reggie Chavers and Mark Chavers Partners."

Gary testified that he did not know that the list of credit references was faxed to Epsco. In addition, he testified that his signature was not at the bottom of the fax. He testified that his former secretary might have signed his name to the fax; however, he stated that he did not authorize his secretary to sign or fax a list of credit references to Epsco. Moreover, Gary testified that the first time he saw the list of credit references was at the bench trial.

This court gives deference to the superior position of the trial judge to determine the credibility of the witnesses and the weight to be accorded their testimony. [Citations] Though there was a dispute concerning whether Gary faxed the list to Epsco, the trial court found that Epsco received the faxed credit references from CWC and relied on CWC's statement that Reggie and Mark were partners. The trial court's finding is not clearly erroneous.

The Fax Cover Sheet

At trial, Epsco introduced Plaintiff's Exhibit # 2, a fax cover sheet from "Chavers Construction" to Epsco. The fax cover sheet was dated July 19, 2000. The fax cover sheet contained the address, telephone number, and fax number of the business. Listed under this information was "Gary, Reggie, or Mark Chavers." Epsco argues that Gary, Reggie, and Mark are all listed on the fax cover sheet, and that this indicates that they were holding themselves out to the public as partners of the business. The trial court's finding that the fax cover sheet indicated that Reggie and Mark were holding themselves out as partners of CWC is not clearly erroneous.

The Epsco Personnel Credit Application

Epsco introduced Plaintiff's Exhibit # 9, a personnel credit application, which was received from CWC. Adams testified that the exhibit represented a completed credit application that she received from CWC. The type of business checked on the credit application is "partnership." Adams testified that the application showed the company to be a partnership, and that this information was relied upon in extending credit. Clegg testified that he viewed the credit application which indicated that CWC was a partnership, and that his decision to extend credit to CWC was based, in part, on his belief that CWC was a partnership. Gary denied filling out the credit application form.

It was within the trial court's discretion to find Adams's and Clegg's testimony more credible than Gary's testimony and to determine that Epsco relied on the statement of partnership on the credit application before extending credit to CWC. The trial court's finding concerning the credit application is not clearly erroneous.

The Checks to Epsco

Epsco argues that Plaintiff's Exhibit # 3 and Plaintiff's Exhibit # 11, checks written to Epsco showing the CWC account to be in the name of "Gary A. or Reggie J. Chavers," indicates that Reggie was holding himself out to be a partner of CWC. Plaintiff's Exhibit # 3 was signed by Gary, and Plaintiff's Exhibit # 11 was signed by Reggie. The checks are evidence that Reggie was holding himself out to the public as a partner of CWC, and Epsco could have detrimentally relied on the checks before extending credit to CWC. The trial court was not clearly erroneous in finding that the checks supported a finding of partnership by estoppel.

The Business Card

Epsco introduced Plaintiff's Exhibit # 4, a business card that states "Chavers Welding, Construction & Crane Service." Listed on the card as "owners" are Gary Chavers and Reggie Chavers. Gary testified that the business cards were printed incorrectly, and that Reggie's name should not have been included as an owner. He also testified that some of the cards might have been handed out, and that it was possible that he might have given one of the cards to a business listed as one of CWC's credit references on Plaintiff's Exhibit # 1.

The business card listing Reggie as an owner indicates that Reggie was holding himself out as a partner. As we stated in [Citation] when a person holds himself out as a member of partnership, any one dealing with the firm on the faith of such representation is entitled to assume the relation continues until notice of some kind is given of its discontinuance. There is no indication that Reggie ever informed any person who received a business card that the business relationship listed on the card was incorrect or had been discontinued. The trial court's finding concerning the business card is not clearly erroneous.

The Dealership Application

Epsco introduced Plaintiff's Exhibit # 5, an application form from "Chavers Welding," signed by Reggie, seeking a dealership from Sukup Manufacturing. The application, dated January 23, 1997, lists "Gary & Reggie Chavers" as owners of "Chavers Welding." The application is signed by Reggie. Reggie admits that he signed the dealership application and represented that he was an owner

of “Chavers Welding,” but he dismisses his statement of ownership as mere “puffery” on his part. Epsco argues that instead, the application shows that Reggie was holding himself out to the public as being a partner. The trial court’s determination that Reggie’s dealership application supports a finding of partnership by estoppel is not clearly erroneous.

In sum, the trial court was not clearly erroneous in finding that Reggie and Mark held themselves out as partners of CWC and that Epsco detrimentally relied on the existence of the partnership before extending credit to CWC. The appellants argue that even if we find Reggie liable based upon partnership by estoppel, there was scant proof of Mark being liable based upon partnership by estoppel. We disagree. We are aware that some examples of holding out cited in the trial court’s order pertain only to Reggie. However, the representations attributed to both Reggie and Mark are sufficient proof to support the trial court’s finding that both Reggie and Mark are estopped from denying liability to Epsco.

Affirmed.

? Case Questions

1. What is the rationale for the doctrine of partnership by estoppel?
2. Gary and Reggie claimed the evidence brought forth to show the existence of a partnership was unconvincing. How credible were their claims?

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12.4: Summary and Exercises

Summary

The basic law of partnership is found in the Uniform Partnership Act and Revised Uniform Partnership Act. The latter has been adopted by thirty-five states. At common law, a partnership was not a legal entity and could not sue or be sued in the partnership name. Partnership law defines a partnership as “an association of two or more persons to carry on as co-owners a business for profit.” The Uniform Partnership Act (UPA) assumes that a partnership is an aggregation of individuals, but it also applies a number of rules characteristic of the legal entity theory. The Revised Uniform Partnership Act (RUPA) assumes a partnership is an entity, but it applies one crucial rule characteristic of the aggregate theory: the partners are ultimately liable for the partnership’s obligations. Thus a partnership may keep business records as if it were a legal entity, may hold real estate in the partnership name, and may sue and be sued in federal court and in many state courts in the partnership name.

Partnerships may be created informally. Among the clues to the existence of a partnership are (1) co-ownership of a business, (2) sharing of profits, (3) right to participate in decision making, (4) duty to share liabilities, and (5) manner in which the business is operated. A partnership may also be formed by implication; it may be formed by estoppel when a third party reasonably relies on a representation that a partnership in fact exists.

No special rules govern the partnership agreement. As a practical matter, it should sufficiently spell out who the partners are, under what name they will conduct their business, the nature and scope of the business, capital contributions of each partner, how profits are to be divided, and similar pertinent provisions. An oral agreement to form a partnership is valid unless the business cannot be performed wholly within one year from the time that the agreement is made. However, most partnerships have no fixed terms and hence are “at-will” partnerships not subject to the Statute of Frauds.

Exercises

1. Able, Baker, and Carr own, as partners, a warehouse. The income from the warehouse during the current year is $300,000, two-thirds of which goes to Able. Who must file a tax return listing this as income, the partnership or Able? Who pays the tax, the partnership or Able?
2. The Havana Club operated in Salt Lake City under a lease running to defendant Dale Bowen, who owned the equipment, furnishings, and inventory. He did not himself work in operating the club. He made an oral agreement with Frances Cutler, who had been working for him as a bartender, that she take over the management of the club. She was to have the authority and the responsibility for the entire active management and operation: to purchase the supplies, pay the bills, keep the books, hire and fire employees, and do whatever else was necessary to run the business. As compensation, the arrangement was for a down-the-middle split; each was to receive $300 per week plus one half of the net profits. This went on for four years until the city took over the building for a redevelopment project. The city offered Bowen $30,000 as compensation for loss of business while a new location was found for the club. Failing to find a suitable location, the parties decided to terminate the business. Bowen then contended he was entitled to the entire $30,000 as the owner, Cutler being an employee only. She sued to recover half as a partner. What was the result? Decide and discuss.
3. Raul, a business student, decided to lease and operate an ice cream stand during his summer vacation. Because he could not afford rent payments, his lessor agreed to take 30 percent of the profits as rent and provide the stand and the parcel of real estate on which it stood. Are the two partners?
4. Able, Baker, and Carr formed the ABC Partnership in 2001. In 2002 Able gave her three sons, Duncan, Eldon, and Frederick, a gift of her 41 percent interest in the partnership to provide money to pay for their college expenses. The sons reported income from the partnership on their individual tax returns, and the partnership reported the payment to them on its information return. The sons were listed as partners on unaudited balance sheets in 2003, and the 2004 income statement listed them as partners. The sons never requested information about the management of the firm, never attended any meetings or voted, and never attempted to withdraw the firm’s money or even speak with the other partners about the firm. Two of the sons didn’t know where the firm was located, but they all once received “management fees” totaling $3,000, without any showing of what the “fees” were for. In 2005, the partnership incurred liability for pension-fund contributions to an employee, and a trustee for the fund asserted that Able’s sons were personally liable under federal law for the money owing because they were partners. The sons moved for summary judgment denying liability. How should the court rule?

5. The Volkmans wanted to build a house and contacted David McNamee for construction advice. He told them that he was doing business with Phillip Carroll. Later the Volkmans got a letter from McNamee on stationery that read “DP Associates,” which they assumed was derived from the first names of David and Phillip. At the DP Associates office McNamee introduced Mr. Volkman to Carroll, who said to Volkman, “I hope we’ll be working together.” At one point during the signing process a question arose and McNamee said, “I will ask Phil.” He returned with the answer to the question. After the contract was signed but before construction began, Mr. Volkman visited the DP Associates office where the two men chatted; Carroll said to him, “I am happy that we will be working with you.” The Volkmans never saw Carroll on the construction site and knew of no other construction supervised by Carroll. They understood they were purchasing Carroll’s services and construction expertise through DP Associates. During construction, Mr. Volkman visited the DP offices several times and saw Carroll there. During one visit, Mr. Volkman expressed concerns about delays and expressed the same to Carroll, who replied, “Don’t worry. David will take care of it.” But David did not, and the Volkmans sued DP Associates, McNamee, and Carroll. Carroll asserted he could not be liable because he and McNamee were not partners. The trial court dismissed Carroll on summary judgment; the Volkmans appealed. How should the court rule on appeal?
6. Wilson and VanBeek want to form a partnership. Wilson is seventeen and VanBeek is twenty-two. May they form a partnership? Explain.
7. Diane and Rachel operate a restaurant at the county fair every year to raise money for the local 4-H Club. They decide together what to serve, what hours to operate, and generally how to run the business. Do they have a partnership?

SELF CHECK QUESTIONS

1. The basic law of partnership is currently found in
    1. common law
    2. constitutional law
    3. statutory law
    4. none of the above
2. Existence of a partnership may be established by
    1. co-ownership of a business for profit
    2. estoppel
    3. a formal agreement
    4. all of the above
3. Which is false?
    1. An oral agreement to form a partnership is valid.
    2. Most partnerships have no fixed terms and are thus not subject to the Statute of Frauds.
    3. Strict statutory rules govern partnership agreements.
    4. A partnership may be formed by estoppel.
4. Partnerships
    1. are not taxable entities
    2. may buy, sell, or hold real property in the partnership name
    3. may file for bankruptcy
    4. have all of the above characteristics
5. Partnerships
    1. are free to select any name not used by another partnership
    2. must include the partners’ names in the partnership name
    3. can be formed by two corporations
    4. cannot be formed by two partnerships

AnswerS

1. c
2. d
3. c

4. d
5. c

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CHAPTER OVERVIEW

13: Business Law - Limited Liability Companies

Learning Objectives

After reading this chapter, you should understand the following:

- The limited partnership
- The limited liability company
- Other hybrid business forms: the sub-S corporation, limited liability partnerships, and limited liability limited partnerships

This chapter provides a bridge between the partnership and the corporate form. It explores several types of associations that are hybrid forms—that is, they share some aspects of partnerships and some of corporations. Corporations afford the inestimable benefit of limited liability, partnerships the inestimable benefit of limited taxation. Businesspeople always seek to limit their risk and their taxation.

13.1: Introduction to Hybrid Business Forms

13.2: Limited Partnerships

13.3: Limited Liability Companies

13.4: Other Forms

13.5: Cases

13.6: Summary and Exercises

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13.1: Introduction to Hybrid Business Forms

At base, whether to allow businesspeople and investors to grasp the holy grail of limited liability is a political issue. When we say a person is “irresponsible,” it means he (or she, or it) does not take responsibility for his harmful actions; the loss is borne by others. Politically speaking, there is an incentive to allow businesspeople insulation from liability: it encourages them to take risks and invest, thus stimulating economic activity and forestalling unemployment. So the political trade-off with allowing various inventive forms of business organization is between providing business actors with the security that they will lose only their calculable investment, thus stimulating the economy, versus the “moral hazard” of allowing them to emerge mostly unscathed from their own harmful or foolish activities, thus externalizing resulting losses upon others. Some people feel that during the run-up to the “Great Recession” of 2007–09, the economic system allowed too much risk taking. When the risky investments collapsed, though, instead of forcing the risk takers to suffer loss, the government intervened—it “bailed them out,” as they say, putting the consequences of the failed risks on the taxpayer.

The risk-averseness and inventiveness of businesspeople is seemingly unlimited, as is investors’ urge to make profits through others’ efforts with as little risk as possible. The rationale for the invention of these hybrid business forms, then, is (1) risk reduction and (2) tax reduction. Here we take up the most common hybrid types first: limited partnerships and limited liability companies. Then we cover them in the approximate chronological order of their invention: sub-S corporations, limited liability partnerships, and limited liability limited partnerships. All these forms are entities.

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13.2: Limited Partnerships

Learning Objectives

By the end of this section, you will be able to:

- Governing law and definition
- Creation and capitalization
- Control and compensation
- Liabilities
- Taxation
- Termination

Governing Law and Definition

The limited partnership is attractive because of its treatment of taxation and its imposition of limited liability on its limited partners.

Governing Law

The original source of limited partnership law is the Uniform Limited Partnership Act (ULPA), which was drafted in 1916. A revised version, the Revised Uniform Limited Partnership Act (RULPA), was adopted by the National Conference of Commissioners on Uniform Laws in 1976 and further amended in 1985 and in 2001.

The 2001 act was drafted for a world in which limited liability partnerships and limited liability companies can meet many of the needs formerly met by limited partnerships. This Act therefore targets two types of enterprises that seem largely beyond the scope of LLPs and LLCs: (i) sophisticated, manager-entrenched commercial deals whose participants commit for the long term, and (ii) estate planning arrangements (family limited partnerships). The Act accordingly assumes that, more often than not, people utilizing it will want (1) strong centralized management, strongly entrenched, and (2) passive investors with little control over or right to exit the entity. The Act's rules, and particularly its default rules, have been designed to reflect these assumptions."Uniform Limited Partnership Act (2001), Prefatory Note," NCCUSL Archives, www.law.upenn.edu/bll/archives/ulc/ulpa/final2001.pdf.

All states except Louisiana adopted the 1976 or 1985 act—most opting for the 1985 version—and sixteen states have adopted the 2001 version. The acts may be properly referred to with a hyphen: "ULPA-1985," or "ULPA-2001"; the word *revised* has been dropped. Here, we mainly discuss ULPA-1985. The Uniform Partnership Act (UPA) or the Revised Uniform Partnership Act (RUPA) also applies to limited partnerships except where it is inconsistent with the limited partnership statutes. The ULPA-2001 is not so much related to UPA or RUPA as previous versions were.

Definition

A limited partnership (LP) is defined as "a partnership formed by two or more persons under the laws of a State and having one or more general partners and one or more limited partners."ULPA, Section 102(11). The form tends to be attractive in business situations that focus on a single or limited-term project, such as making a movie or developing real estate; it is also widely used by private equity firms.

Creation and Capitalization

Unlike a general partnership, a limited partnership is created in accordance with the state statute authorizing it. There are two categories of partners: limited and general. The limited partners capitalize the business and the general partners run it.

Creation

The act requires that the firm's promoters file a certificate of limited partnership with the secretary of state; if they do not, or if the certificate is substantially defective, a general partnership is created. The certificate must be signed by all general partners. It must include the name of the limited partnership (which must include the words *limited partnership* so the world knows there are owners of the firm who are not liable beyond their contribution) and the names and business addresses of the general partners. If there are any changes in the general partners, the certificate must be amended. The general partner may be, and often is, a corporation.

Having a general partner be a corporation achieves the goal of limited liability for everyone, but it is somewhat of a "clunky" arrangement. That problem is obviated in the limited liability company, discussed in Section 20.2. Here is an example of a limited partnership operating agreement: http://www.wyopa.com/Articles%20of%20limited%20partnership.htm.

Any natural person, partnership, limited partnership (domestic or foreign), trust, estate, association, or corporation may become a partner of a limited partnership.

Capitalization

The money to capitalize the business typically comes mostly from the limited partners, who may themselves be partnerships or corporations. That is, the limited partners use the business as an investment device: they hope the managers of the firm (the general partners) will take their contributions and give them a positive return on it. The contributions may be money, services, or property, or promises to make such contributions in the future.

Control and Compensation

Control

Control is *not* generally shared by both classes of partners.

General Partners

The control of the limited partnership is in the hands of the general partners, which may—as noted—be partnerships or corporations.

Limited Partners

Under ULPA-1985 and its predecessors, a limited partner who exercised any significant control would incur liability like a general partner as to third parties who believed she was one (the "control rule"). However, among the things a limited partner could do that would *not* risk the loss of insulation from personal liability were these "safe harbors":

- Acting as an agent, employee, or contractor for the firm; or being an officer, director, or shareholder of a corporate general partner
- Consulting with the general partner of the firm
- Requesting or attending a meeting of partners
- Being a surety for the firm
- Voting on amendments to the agreement, on dissolution or winding up the partnership, on loans to the partnership, on a change in its nature of business, on removing or admitting a general or limited partner

However, see Section 20.3.3 "Limited Liability Limited Partnerships" for how this "control rule" has been abolished under ULPA-2001.

General partners owe fiduciary duties to other general partners, the firm, and the limited partners; limited partners who do not exercise control do not owe fiduciary duties. See Figure 20.1.



Figure 20.1 The Limited Partnership under ULPA-1985

The partnership agreement may specify which general or limited partners have the right to vote on any matter, but if the agreement grants limited partners voting rights beyond the "safe harbor," a court may abolish that partner's limited liability.

Assignment of Partnership Rights

Limited partnership interests may be assigned in whole or in part; if in whole, the assignor ceases to be a partner unless otherwise agreed. An assignment is usually made as security for a loan. The assignee becomes a new limited partner only if all the others consent or if provided for in the certificate; the assignment does not cause dissolution. The happy ease with which a limited partner can divest himself of the partnership interest makes the investment in the firm here more like that in a corporation than in a general partnership.

Inspection of Books

Limited partners have the right to inspect the firm's books and records, they may own competing interests, they may be creditors of the firm, and they may bring derivative suits on the firm's behalf. They may not withdraw their capital contribution if that would impair creditors' rights.

Addition of New Partners

Unless the partnership agreement provides otherwise (it usually does), the admission of additional limited partners requires the written consent of all. A general partner may withdraw at any time with written notice; if withdrawal is a violation of the agreement, the limited partnership has a right to claim of damages. A limited partner can withdraw any time after six months' notice to each general partner, and the withdrawing partner is entitled to any distribution as per the agreement or, if none, to the fair value of the interest based on the right to share in distributions.

Compensation

We noted in discussing partnerships that the partners are not entitled to "compensation," that is, payment for their work; they are entitled to a share of the profits. For limited partnerships, the rule is a bit different.

General Partners

Often, general partners are paid for their management work on a sliding scale, receiving a greater share of each dollar of cash flow as the limited partners' cash distributions rise, thus giving the general partner an incentive to increase limited-partner distributions.

Limited Partners

Profits or losses are shared as agreed in the certificate or, if there is no agreement, in accordance with the percentages of capital contributions made.

Liabilities

Liability is not shared.

General Partners

The general partners are liable as in a general partnership, and they have the same fiduciary duty and duty of care as partners in a general partnership. However, see the discussion in Section 20.3.3 "Limited Liability Limited Partnerships" of the newest type of LP, the limited liability limited partnership (triple LP), where the general partner is also afforded limited liability under ULPA-2001.

Limited Partners

The limited partners are only liable up to the amount of their capital contribution, provided the surname of the limited partner does not appear in the partnership name (unless his name is coincidentally the same as that of one of the general partners whose name does appear) and provided the limited partner does not participate in control of the firm. See Section 20.4.1 "Limited Partnerships: Limited Partners' Liability for Managing Limited Partnership" for a case that highlights liability issues for partners.

We have been discussing ULPA-1985 here. But in a world of limited liability companies, limited liability partnerships, and limited liability limited partnerships, "the control rule has become an anachronism"; ULPA-2001 "provides a full, status-based liability shield for each limited partner, 'even if the limited partner participates in the management and control of the limited partnership.'ULPA-2001, Section 303. The section thus eliminates the so-called control rule with respect to personal liability for entity obligations and brings limited partners into parity with LLC members, LLP partners and corporate shareholders."Official

Comment to Uniform Limited Partnership Act 2001, Section 303. And as will be noted in Section 20.3.3 “Limited Liability Limited Partnerships” under ULPA-2001 the *general* partner is also shielded from liability.

Taxation

Assuming the limited partnership meets a minimum number of criteria related to limited liability, centralized management, duration, and transferability of ownership, it can enjoy the benefits of pass-through taxation; otherwise it will be taxed as a corporation. Pass-through (“conduit”) taxation is usually very important to partners.

Termination

The limited partnership’s termination involves the same three steps as in a general partnership: (1) dissolution, (2) winding up, and (3) termination.

Dissolution

Dissolution of a limited partnership is the first step toward termination (but termination does not necessarily follow dissolution). The limited partners have no power to dissolve the firm except on court order, and the death or bankruptcy of a limited partner does not dissolve the firm. The following events may cause dissolution: (1) termination of the partnership as per the certificate’s provisions; (2) termination upon an event specified in the partnership agreement; (3) the unanimous written consent of the partners; (4) the withdrawal of a general partner, unless at least one remains and the agreement says one is enough, or if within ninety days all partners agree to continue; (5) an event that causes the business to be illegal; and (6) judicial decree of dissolution when it is not reasonable to carry on. If the agreement has no term, its dissolution is not triggered by some agreed-to event, and none of the other things listed cause dissolution.

Dissolution requires the filing of a certificate of cancellation with the state if winding up commences.

Winding Up

General partners who have not wrongfully dissolved the partnership may wind it up, and so may the limited partners if all the general partners have wrongfully dissolved the firm. Any partner or that person’s legal representative can petition a court for winding up, with cause.

Upon winding up, the assets are distributed (1) to creditors, including creditor-partners, not including liabilities for distributions of profit; (2) to partners and ex-partners to pay off unpaid distributions; (3) to partners as return of capital contributions, unless otherwise agreed; and (4) to partners for partnership interests in proportion as they share in distributions, unless otherwise agreed. No distinction is made between general and limited partners—they share equally, unless otherwise agreed. When winding up is completed, the firm is terminated.

It is worth reiterating the part about “unless otherwise agreed”: people who form any kind of a business organization—partnership, a hybrid form, or corporations—can to a large extent choose to structure their relationship as they see fit. Any aspect of the company’s formation, operation, or ending that is not included in an agreement flops into the default provisions of the relevant law.

Key Takeaway

A limited partnership is a creature of statute: it requires filing a certificate with the state because it confers on some of its members the marvel of limited liability. It is an investment device composed of one or more general partners and one or more limited partners; limited partners may leave with six months’ notice and are entitled to an appropriate payout. The general partner is liable as a partner is a general partnership; the limited partners’ liability is limited to the loss of their investment, unless they exercise so much control of the firm as to become general partners. The general partner is paid, and the general and limited partners split profit as per the agreement or, if none, in the proportion as they made capital contributions. The firm is usually taxed like a general partnership: it is a conduit for the partners’ income. The firm is dissolved upon the end of its term, upon an event specified in the agreement, or in several other circumstances, but it may have indefinite existence.

Exercises

1. Why does the fact that the limited liability company provides limited liability for some of its members mean that a state certificate must be filed?

2. What liability has the general partner? The limited partner?
3. How easy is it for the limited partner to dispose of (sell) her partnership interest?

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13.3: Limited Liability Companies

Learning Objectives

By the end of this section, you will be able to:

- Understand the history and law governing limited liability companies (LLCs).
- Identify the creation and capitalization of an LLC.
- Understand control and compensation of a firm.
- Recognize liabilities in the LLC form.
- Explain the taxation of an LLC.
- Identify how LLCs are terminated.

History and Law Governing Limited Liability Companies

History of the Limited Liability Company

The limited liability company (LLC) gained sweeping popularity in the late twentieth century because it combines the best aspects of partnership and the best aspects of corporations: it allows all its owners (members) insulation from personal liability and pass-through (conduit) taxation. The first efforts to form LLCs were thwarted by IRS rulings that the business form was too much like a corporation to escape corporate tax complications. Tinkering by promoters of the LLC concept and flexibility by the IRS solved those problems in interesting and creative ways.

Corporations have six characteristics: (1) associates, (2) an objective to carry on a business and divide the gains, (3) continuity of life, (4) centralized management, (5) limited liability, and (6) free transferability of interests. Partnerships also, necessarily, have the first two corporate characteristics; under IRS rulings, if the LLC is *not* to be considered a corporation for tax purposes, it must lack at least one-half of the remaining four characteristics of a corporation: the LLC, then, must lack two of these corporate characteristics (otherwise it will be considered a corporation): (1) limited liability, (2) centralized management, (3) continuity of life, or (4) free transferability of interests. But limited liability is essential and centralized management is necessary for passive investors who don't want to be involved in decision making, so pass-through taxation usually hinges on whether an LLC has continuity of life and free transferability of accounts. Thus it is extremely important that the LLC promoters avoid the corporate characteristics of continuity of life and free transferability of interests.

We will see how the LLC can finesse these issues.

Governing Law

All states have statutes allowing the creation of LLCs, and while a Uniform Limited Liability Company Act has been promulgated, only eight states have adopted it as of January 2011. That said, the LLC has become the entity of choice for many businesses.

Creation and Capitalization

Creation of the LLC

An LLC is created according to the statute of the state in which it is formed. It is required that the LLC members file a "certificate of organization" with the secretary of state, and the name must indicate that it is a limited liability company. Partnerships and limited partnerships may convert to LLCs; the partners' previous liability under the other organizational forms is not affected, but going forward, limited liability is provided. The members' operating agreement spells out how the business will be run; it is subordinate to state and federal law. Unless otherwise agreed, the operating agreement can be amended only by unanimous vote. The LLC is an entity. Foreign LLCs must register with the secretary of state before doing business in a "foreign" state, or they cannot sue in state courts.

As compared with corporations, the LLC is not a good form if the owners expect to have multiple investors or to raise money from the public. The typical LLC has relatively few members (six or seven at most), all of whom usually are engaged in running the firm.

Most early LLC statutes, at least, prohibited their use by professionals. That is, practitioners who need professional licenses, such as certified public accountants, lawyers, doctors, architects, chiropractors, and the like, could not use this form because of concern about what would happen to the standards of practice if such people could avoid legitimate malpractice claims. For that reason, the limited liability partnership was invented.

Capitalization

Capitalization is like a partnership: members contribute capital to the firm according to their agreement. As in a partnership, the LLC property is not specific to any member, but each has a personal property interest in general. Contributions may be in the form of cash, property or services rendered, or a promise to render them in the future.

Control and Compensation

Control

The LLC operating agreement may provide for either a member-managed LLC or a manager-managed (centralized) LLC. If the former, all members have actual and apparent authority to bind the LLC to contracts on its behalf, as in a partnership, and all members' votes have equal weight unless otherwise agreed. Member-managers have duty of care and a fiduciary duty, though the parameters of those duties vary from state to state. If the firm is manager managed, only managers have authority to bind the firm; the managers have the duty of care and fiduciary duty, but the nonmanager members usually do not. Some states' statutes provide that voting is based on the financial interests of the members. Most statutes provide that any extraordinary firm decisions be voted on by all members (e.g., amend the agreement, admit new members, sell all the assets prior to dissolution, merge with another entity). Members can make their own rules without the structural requirements (e.g., voting rights, notice, quorum, approval of major decisions) imposed under state corporate law.

If the firm has a centralized manager system, it gets a check in its "corporate-like" box, so it will need to make sure there are enough noncorporate-like attributes to make up for this one. If it looks too much like a corporation, it will be taxed like one.

One of the real benefits of the LLC as compared with the corporation is that no annual meetings are required, and no minutes need to be kept. Often, owners of small corporations ignore these formalities to their peril, but with the LLC there are no worries about such record keeping.

Compensation

Distributions are allocated among members of an LLC according to the operating agreement; managing partners may be paid for their services. Absent an agreement, distributions are allocated among members in proportion to the values of contributions made by them or required to be made by them. Upon a member's dissociation that does not cause dissolution, a dissociating member has the right to distribution as provided in the agreement, or—if no agreement—the right to receive the fair value of the member's interest within a reasonable time after dissociation. No distributions are allowed if making them would cause the LLC to become insolvent.

Liability

The great accomplishment of the LLC is, again, to achieve limited liability for all its members: no general partner hangs out with liability exposure.

Liability to Outsiders

Members are not liable to third parties for contracts made by the firm or for torts committed in the scope of business (but of course a person is always liable for her own torts), regardless of the owner's level of participation—unlike a limited partnership, where the general partner is liable. Third parties' only recourse is as against the firm's property. See *Puleo v. Topel*, (see Section 20.4.2 "Liability Issues in LLCs"), for an analysis of owner liability in an LLC.

Internal Liabilities

Unless the operating agreement provides otherwise, members and managers of the LLC are generally not liable to the firm or its members except for acts or omissions constituting gross negligence, intentional misconduct, or knowing violations of the law. Members and managers, though, must account to the firm for any personal profit or benefit derived from activities not consented to

by a majority of disinterested members or managers from the conduct of the firm's business or member's or managers use of firm property—which is the same as in partnership law.

Taxation

Assuming the LLC is properly formed so that it is not too much like a corporation, it will—upon its members' election—be treated like a partnership for tax purposes.

Termination

Termination, loosely speaking, refers either to how the entity's life as a business ends (continuity of life) or to how a member's interest in the firm ends—that is, how freely the interest is transferable.

Continuity of Life

The first step in the termination of the LLC is dissolution, though dissolution is not necessarily followed by termination.

Dissolution and Winding Up

The IRS has determined that continuity of life does *not* exist "if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization,"Treasury Regulation, § 301.7701-2(b)(1). and that if one of these events occurs, the entity may continue only with the members' unanimous consent. Dissolution may occur even if the business is continued by the remaining members.

The typical LLC statute provides that an LLC will dissolve upon (1) expiration of the LLC's term as per its agreement; (2) events specified in the agreement; (3) written consent of all members; (4) an "event of dissociation" of a member, unless within ninety days of the event all remaining members agree to continue, or the right to continue is stated in the LLC; (5) the entry of a judicial decree of dissolution; (6) a change in membership that results in there being fewer than two members; or (7) the expiration of two years after the effective date of administrative dissolution.

And an "event of dissociation" is typically defined as (1) a member's voluntary withdrawal, (2) her assignment of the entire LLC interest, (3) her expulsion, (4) her bankruptcy, (5) her becoming incompetent, (6) dissolution of an entity member (as an LLC, limited partnership, or corporation), or (7) any other event specified in the agreement.

Thus under most statutes' default position, if a member dies, becomes insane or bankrupt, retires, resigns, or is expelled, the LLC will dissolve *unless* within ninety days the rest of the members unanimously agree to continue. And by this means the firm does *not* have continuity of life. Some states provide opportunities for even more flexibility regarding the "unanimous" part. In the mid-1990s, the IRS issued revenue rulings (as opposed to regulations) that it would be enough if a "majority in interest" of remaining partners agreed to continue the business, and the "flexible" statute states adopted this possibility (the ones that did not are called "bulletproof" statutes). "Majority in interests" means a majority of profits and capital.

If the firm does dissolve, some states require public filings to that effect. If dissolution leads to winding up, things progress as in a general partnership: the business at hand is finished, accounts are rendered, bills paid, assets liquidated, and remaining assets are distributed to creditors (including member and manager creditors, but not for their shares in profits); to members and past members for unpaid distributions; to members for capital contributions; and to members as agreed or in proportion to contributions made. Upon dissolution, actual authority of members or managers terminates except as needed to wind up; members may have apparent authority, though, unless the third party had notice of the dissolution.

Free Transferability of Interest

Again, the problem here is that if a member's interest in the LLC is as freely transferable as a shareholder's interest in a corporation (an owner can transfer all attributes of his interest without the others' consent), the LLC will probably be said to have a check mark in the "corporate-like" box: too many of those and the firm will not be allowed pass-through taxation. Thus the trick for the LLC promoters is to limit free transferability enough to pass the test of not being a corporation, but not limit so much as to make it really difficult to divest oneself of the interest (then it's not a very liquid or desirable investment).

Some states' LLC statutes have as the default rule that the remaining members must unanimously consent to allow an assignee or a transferee of a membership interest to participate in managing the LLC. Since this prevents a member from transferring *all*

attributes of the interest (the right to participate in management isn't transferred or assigned), the LLC formed under the default provision will not have "free transferability of interest." But if the LLC agreement allows *majority* consent for the transfer of all attributes, that also would satisfy the requirement that there not be free transferability of interests. Then we get into the question of how to define "majority": by number of members or by value of their membership? And what if only the managing partners need to consent? Or if there are two classes of membership and the transfer of interests in one class requires the consent of the other? The point is that people keep pushing the boundaries to see how close their LLC can come to corporation-like status without being called a corporation.

Statutes for LLCs allow other business entities to convert to this form upon application.

Key Takeaway

The limited liability company has become the entity of choice for many businesspeople. It is created by state authority that, upon application, issues the "certificate of organization." It is controlled either by managers or by members, it affords its members limited liability, and it is taxed like a partnership. But these happy results are obtained only if the firm lacks enough corporate attributes to escape being labeled as a corporation. To avoid too much "corporateness," the firm's certificate usually limits its continuity of life and the free transferability of interest. The ongoing game is to finesse these limits: to make them as nonconstraining as possible, to get right up to the line to preserve continuity, and to make the interest as freely transferable as possible.

Exercises

1. What are the six attributes of a corporation? Which are automatically relevant to the LLC? Which two corporate attributes are usually dropped in an LLC?
2. Why does the LLC not want to be treated like a corporation?
3. Why does the name of the LLC have to include an indication that it is an LLC?
4. How did LLCs finesse the requirement that they not allow too-free transferability of the interest?

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13.4: Other Forms

Learning Objectives

By the end of this section, you will be able to:

- Recognize other business forms: sub-S corporations, limited liability partnerships, and limited liability limited partnerships.

Sub-S Corporation

History

The sub-S corporation or the S corporation gets its name from the IRS Code, Chapter 1, Subchapter S. It was authorized by Congress in 1958 to help small corporations and to stem the economic and cultural influence of the relatively few, but increasingly powerful, huge multinational corporations. According to the website of an S corporation champion, "a half century later, S corporations are the most popular corporate structure in America. The IRS estimates that there were 4.5 million S corporation owners in the United States in 2007—about twice the number of C [standard] corporations.""The History and Challenges of America's Dominant Business Structure," *S Corp: Defending America's Small and Family-Owned Businesses*, http://www.s-corp.org/our-history.

Creation and Capitalization

The S corporation is a regular corporation created upon application to the appropriate secretary of state's office and operated according to its bylaws and shareholders' agreements. There are, however, some limits on how the business is set up, among them the following:

- It must be incorporated in the United States.
- It cannot have more than one hundred shareholders (a married couple counts as one shareholder).
- The only shareholders are individuals, estates, certain exempt organizations, or certain trusts.
- Only US citizens and resident aliens may be shareholders.
- The corporation has only one class of stock.
- With some exceptions, it cannot be a bank, thrift institution, or insurance company.
- All shareholders must consent to the S corporation election.
- It is capitalized as is a regular corporation.

Liability

The owners of the S corporation have limited liability.

Taxation

Taxation is the crux of the matter. The S corporation pays no corporate income tax (unless it has a lot of passive income). The S corporation's shareholders include on their personal income statements, and pay tax on, their share of the corporation's separately stated items of income, deduction, and loss. That is, the S corporation avoids the dreaded double taxation of corporate income.

Transferability of Ownership

S corporations' shares can be bought or sold via share purchase agreements, and all changes in the ownership are reflected in the share ledger in the corporate minute book.

Limited Liability Partnerships

Background

In 1991, Texas enacted the first limited liability partnership (LLP) statute, largely in response to the liability that had been imposed on partners in partnerships sued by government agencies in relation to massive savings and loan failures in the 1980s.Christine M. Przybysz, "Shielded Beyond State Limits: Examining Conflict-Of-Law Issues In Limited Liability Partnerships," *Case Western*

Reserve Law Review 54, no. 2 (2003): 605. (Here we see an example of the legislature allowing business owners to externalize the risks of business operation.) More broadly, the success of the limited liability company attracted the attention of professionals like accountants, lawyers, and doctors who sought insulation from personal liability for the mistakes or malpractice of their partners. Their wish was granted with the adoption in all states of statutes authorizing the creation of the limited liability partnership in the early 1990s. Most partnership law under the Revised Uniform Partnership Act applies to LLPs.

Creation

Members of a partnership (only a majority is required) who want to form an LLP must file with the secretary of state; the name of the firm must include "limited liability partnership" or "LLP" to notify the public that its members will not stand personally for the firm's liabilities.

Liability

As noted, the purpose of the LLP form of business is to afford insulation from liability for its members. A typical statute provides as follows: "Any obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort or otherwise, is solely the obligation of the partnership. A partner is not personally liable, directly or indirectly, by way of indemnification, contribution, assessment or otherwise, for such an obligation solely by reason of being or so acting as a partner."Revised Code of Washington (RCW), Section 25.05.130.

However, the statutes vary. The early ones only allowed limited liability for negligent acts and retained unlimited liability for other acts, such as malpractice, misconduct, or wrongful acts by partners, employees, or agents. The second wave eliminated all these as grounds for unlimited liability, leaving only breaches of ordinary contract obligation. These two types of legislation are called *partial shield* statutes. The third wave of LLP legislation offered *full shield* protection—no unlimited liability at all. Needless to say, the full-shield type has been most popular and most widely adopted. Still, however, many statutes require specified amounts of professional malpractice insurance, and partners remain fully liable for their own negligence or for wrongful acts of those in the LLP whom they supervise.

In other respects, the LLP is like a partnership.

Limited Liability Limited Partnerships

The progress toward achieving limited liability continues. A limited liability limited partnership (LLLP, or triple LP) is the latest invention. It is a limited partnership that has invoked the LLLP provisions of its state partnership law by filing with a specified public official the appropriate documentation to become an LLLP. This form completely eliminates the automatic personal liability of the general partner for partnership obligations and, under most statutes, also eliminates the "control rule" liability exposure for all limited partners. It is noteworthy that California law does not allow for an LLLP to be formed in California; however, it does recognize LLLPs formed in other states. A "foreign" LLLP doing business in California must register with the secretary of state. As of February 2011, twenty-one states allow the formation of LLLPs.

The 2001 revision of the Uniform Limited Partnership Act (ULPA) provides this definition of an LLLP: "'Limited liability limited partnership'…means a limited partnership whose certificate of limited partnership states that the limited partnership is a limited liability limited partnership." "Uniform Limited Partnership Act (2001)," NCCUSL Archives, www.law.upenn.edu/bll/archives/ulc/ulpa/final2001.htm; ULPA Section, 102(9). Section 404(c) gets to the point: "An obligation of a limited partnership incurred while the limited partnership is a limited liability limited partnership, whether arising in contract, tort, or otherwise, is solely the obligation of the limited partnership. A general partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for such an obligation solely by reason of being or acting as a general partner. This subsection applies despite anything inconsistent in the partnership agreement that existed immediately before the consent required to become a limited liability limited partnership[.]"ULPA Section, 404(c).

In the discussion of limited partnerships, we noted that ULPA-2001 eliminates the "control rule" so that limited partners who exercise day-to-day control are *not* thereby liable as general partners. Now, in the section quoted in the previous paragraph, the *general partner's* liability for partnership obligations is vaporized too. (Of course, the general partner is liable for its, his, or her own torts.) The preface to ULPA-2001 explains, "In a limited liability limited partnership ('LLLP'), no partner—whether general or limited—is liable on account of partner status for the limited partnership's obligations. Both general and limited partners benefit

from a full, status-based liability shield that is equivalent to the shield enjoyed by corporate shareholders, LLC members, and partners in an LLP."

Presumably, most existing limited partnerships will switch over to LLLPs. The ULPA-2001 provides that "the Act makes LLLP status available through a simple statement in the certificate of limited partnership."

Ethical Concerns

There was a reason that partnership law imposed personal liability on the partners: people tend to be more careful when they are personally liable for their own mistakes and bad judgment. Many government programs reflect peoples' interest in adverting risk: federal deposit insurance, Social Security, and bankruptcy, to name three. And of course corporate limited liability has existed for two hundred years.See, for example, David A. Moss, "Risk, Responsibility, and the Role of Government," *Drake Law Review* 56, no. 2 (2008): 541. Whether the movement to allow almost anybody the right to a business organization that affords limited liability will encourage entrepreneurship and business activity or whether it will usher in a new era of moral hazard—people being allowed to escape the consequences of their own irresponsibility—is yet to be seen.

Key Takeaway

Businesspeople always prefer to reduce their risks. The partnership form imposes serious potential risk: unlimited personal liability. The corporate form eliminates that risk but imposes some onerous formalities and double taxation. Early on, then, the limited partnership form was born, but it still imposed unlimited liability on the general partner and on the limited partner if she became too actively involved. Congress was induced in the mid-1950s to allow certain small US corporations the right to single taxation, but the sub-S corporation still suffered from various limitations on its structure. In the 1980s, the limited liability company was invented; it has become the entity of choice for many businesspeople, but its availability for professionals was limited. In the late 1980s, the limited liability partnership form gained favor, and in the early 2000s, the limited liability limited partnership finished off unlimited liability for limited partnerships.

Exercises

1. The principal disadvantage of the general partnership is that it imposes unlimited personal liability on the partners. What is the disadvantage of the corporate form?
2. Why isn't the limited partnership an entirely satisfactory solution to the liability problem of the partnership?
3. Explain the issue of "moral hazard" and the business organization form.

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13.5: Cases

Limited Partnerships: Limited Partners' Liability for Managing Limited Partnership

Frigidaire Sales Corp. v. Union Properties, Inc.

562 P.2d 244 (Wash. 1977)

Plaintiff [Frigidaire] entered into a contract with Commercial Investors (Commercial), a limited partnership. Defendants, Leonard Mannon and Raleigh Baxter, were limited partners of Commercial. Defendants were also officers, directors, and shareholders of Union Properties, Inc., the only general partner of Commercial. Defendants controlled Union Properties, and through their control of Union Properties they exercised the day-to-day control and management of Commercial. Commercial breached the contract, and Plaintiff brought suit against Union Properties and Defendants. The trial court concluded that Defendants did not incur general liability for Commercial's obligations by reason of their control of Commercial, and the Court of Appeals affirmed.

[Plaintiff] does not contend that Defendants acted improperly by setting up the limited partnership with a corporation as the sole general partner. Limited partnerships are a statutory form of business organization, and parties creating a limited partnership must follow the statutory requirements. In Washington, parties may form a limited partnership with a corporation as the sole general partner. [Citations]

Plaintiff's sole contention is that Defendants should incur general liability for the limited partnership's obligations under RCW 25.08.070, because they exercised the day-to-day control and management of Commercial. Defendants, on the other hand, argue that Commercial was controlled by Union Properties, a separate legal entity, and not by Defendants in their individual capacities. [RCW 25.08.070 then read: "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as limited partner, he takes part in the control of the business."]

…The pattern of operation of Union Properties was to investigate and conceive of real estate investment opportunities and, when it found such opportunities, to cause the creation of limited partnerships with Union Properties acting as the general partner. Commercial was only one of several limited partnerships so conceived and created. Defendants did not form Union Properties for the sole purpose of operating Commercial. Hence, their acts on behalf of Union Properties were not performed merely for the benefit of Commercial.…

[P]etitioner was never led to believe that Defendants were acting in any capacity other than in their corporate capacities. The parties stipulated at the trial that Defendants never acted in any direct, personal capacity. When the shareholders of a corporation, who are also the corporation's officers and directors, conscientiously keep the affairs of the corporation separate from their personal affairs, and no fraud or manifest injustice is perpetrated upon third persons who deal with the corporation, the corporation's separate entity should be respected. [Citations]

For us to find that Defendants incurred general liability for the limited partnership's obligations under RCW 25.08.070 would require us to apply a literal interpretation of the statute and totally ignore the corporate entity of Union Properties, when Plaintiff knew it was dealing with that corporate entity. There can be no doubt that Defendants, in fact, controlled the corporation. However, they did so only in their capacities as agents for their principal, the corporate general partner. Although the corporation was a separate entity, it could act only through its board of directors, officers, and agents. [Citations] Plaintiff entered into the contract with Commercial. Defendants signed the contract in their capacities as president and secretary-treasurer of Union Properties, the general partner of Commercial. In the eyes of the law it was Union Properties, as a separate corporate entity, which entered into the contract with Plaintiff and controlled the limited partnership.

Further, because Defendants scrupulously separated their actions on behalf of the corporation from their personal actions, Plaintiff never mistakenly assumed that Defendants were general partners with general liability. [Citations] Plaintiff knew Union Properties was the sole general partner and did not rely on Defendants' control by assuming that they were also general partners. If Plaintiff had not wished to rely on the solvency of Union Properties as the only general partner, it could have insisted that Defendants personally guarantee contractual performance. Because Plaintiff entered into the contract knowing that Union Properties was the only party with general liability, and because in the eyes of the law it was Union Properties, a separate entity, which controlled the limited partnership, there is no reason for us to find that Defendants incurred general liability for their acts done as officers of the corporate general partner.

The decision of the Court of Appeals is affirmed.

? Case Questions

1. Frigidaire entered into a contract with Commercial Investors, a limited partnership. The general partner in the limited partnership was Union Properties, Inc., a corporation. Who were the limited partners in the limited partnership? Who were the controlling principals of the corporate general partner?
2. Why is it common for the general partner in a limited partnership to be a corporation?
3. Why does the court reiterate that the plaintiff knew it was dealing with a limited partnership that had a corporate general partner?
4. What could the plaintiff have done in this case to protect itself?
5. The court ruled in favor of the defendants, but is this setup kind of a scam? What is the "moral hazard" problem lurking in this case?

Liability Issues in LLCs

Puleo v. Topel

856 N.E.2d 1152 (Ill. App. 2006)

Plaintiffs Philip Puleo [and others]…appeal the order of the circuit court dismissing their claims against defendant Michael Topel.

The record shows that effective May 30, 2002, Thinktank, a limited liability company (LLC) primarily involved in web design and web marketing, was involuntarily dissolved by the Illinois Secretary of State…due to Thinktank's failure to file its 2001 annual report as required by the Illinois Limited Liability Company Act (the Act) [Citation].

[In December 2002], plaintiffs, independent contractors hired by Topel, filed a complaint against Topel and Thinktank in which they alleged breach of contract, unjust enrichment, and claims under the account stated theory. Those claims stemmed from plaintiffs' contention that Topel, who plaintiffs alleged was the sole manager and owner of Thinktank, knew or should have known of Thinktank's involuntary dissolution, but nonetheless continued to conduct business as Thinktank from May 30, 2002, through the end of August 2002. They further contended that on or about August 30, 2002, Topel informed Thinktank employees and independent contractors, including plaintiffs, that the company was ceasing operations and that their services were no longer needed. Thinktank then failed to pay plaintiffs for work they had performed.…

On September 2, 2003, the circuit granted plaintiffs' motion for judgment on the pleadings against Thinktank. Thereafter, on October 16, 2003, plaintiffs filed a separate motion for summary judgment against Topel [personally]. Relying on [Citation], plaintiffs contended that Topel, as a principal of Thinktank, an LLC, had a legal status similar to a shareholder or director of a corporation, who courts have found liable for a dissolved corporation's debts. Thus, plaintiffs argued that Topel was personally liable for Thinktank's debts.…

…The circuit court denied plaintiffs' motion for summary judgment against Topel.…In doing so, the circuit court acknowledged that Topel continued to do business as Thinktank after its dissolution and that the contractual obligations at issue were incurred after the dissolution.

However…the court entered a final order dismissing all of plaintiffs' claims against Topel with prejudice.…The court stated in pertinent part:

Based upon the Court's…finding that the Illinois Legislature did not intend to hold a member of a Limited Liability Company liable for debts incurred after the Limited Liability Company had been involuntarily dissolved, the Court finds that all of Plaintiffs' claims against Defendant Topel within the Complaint fail as a matter of law, as they are premised upon Defendant Topel's alleged personal liability for obligations incurred in the name of Thinktank LLC after it had been involuntarily dissolved by the Illinois Secretary of State.

Plaintiffs now appeal that order…[contending] that…the circuit court erred in dismissing their claims against Topel. In making that argument, plaintiffs acknowledge that the issue as to whether a member or manager of an LLC may be held personally liable for obligations incurred by an involuntarily dissolved LLC appears to be one of first impression under the Act. That said, plaintiffs assert that it has long been the law in Illinois that an officer or director of a dissolved corporation has no authority to exercise

corporate powers and thus is personally liable for any debts he incurs on behalf of the corporation after its dissolution. [Citations] Plaintiffs reason that Topel, as managing member of Thinktank, similarly should be held liable for debts the company incurred after its dissolution.

We first look to the provisions of the Act as they provided the trial court its basis for its ruling.…

(a) Except as otherwise provided in subsection (d) of this Section, the debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, are solely the debts, obligations, and liabilities of the company. A member or manager is not personally liable for a debt, obligation, or liability of the company solely by reason of being or acting as a member or manager.…

(c) The failure of a limited liability company to observe the usual company formalities or requirements relating to the exercise of its company powers or management of its business is not a ground for imposing personal liability on the members or managers for liabilities of the company.

(d) All or specified members of a limited liability company are liable in their capacity as members for all or specified debts, obligations, or liabilities of the company if:

(1) a provision to that effect is contained in the articles of organization; and

(2) a member so liable has consented in writing to the adoption of the provision or to be bound by the provision.

[Another relevant section provides]:

(a) A limited liability company is bound by a member or manager's act after dissolution that:

(1) is appropriate for winding up the company's business; or

(2) would have bound the company before dissolution, if the other party to the transaction did not have notice of the dissolution.

(b) A member or manager who, with knowledge of the dissolution, subjects a limited liability company to liability by an act that is not appropriate for winding up the company's business is liable to the company for any damage caused to the company arising from the liability.

[The statute] clearly indicates that a member or manager of an LLC is not personally liable for debts the company incurs unless each of the provisions in subsection (d) is met. In this case, plaintiffs cannot establish either of the provisions in subsection (d). They have not provided this court with Thinktank's articles of organization, much less a provision establishing Topel's personal liability, nor have they provided this court with Topel's written adoption of such a provision. As such, under the express language of the Act, plaintiffs cannot establish Topel's personal liability for debts that Thinktank incurred after its dissolution.…

In 1998…the legislature amended [the LLC statute]…and in doing so removed…language which explicitly provided that a member or manager of an LLC could be held personally liable for his or her own actions or for the actions of the LLC to the same extent as a shareholder or director of a corporation could be held personally liable [which would include post-dissolution acts undertaken without authority]. As we have not found any legislative commentary regarding that amendment, we presume that by removing the noted statutory language, the legislature meant to shield a member or manager of an LLC from personal liability. [Citation] "When a statute is amended, it is presumed that the legislature intended to change the law as it formerly existed."

Nonetheless, plaintiffs ask this court to disregard the 1998 amendment and to imply a provision into the Act similar to…the Business Corporation Act. We cannot do so.…When the legislature amended section [the relevant section] it clearly removed the provision that allowed a member or manager of an LLC to be held personally liable in the same manner as provided in section 3.20 of the Business Corporation Act. Thus, the Act does not provide for a member or manager's personal liability to a third party for an LLC's debts and liabilities, and no rule of construction authorizes this court to declare that the legislature did not mean what the plain language of the statute imports.

We, therefore, find that the circuit court did not err in concluding that the Act did not permit it to find Topel personally liable to plaintiffs for Thinktank's debts and liabilities. We agree with plaintiff that the circuit court's ruling does not provide an equitable result. However, the circuit court, like this court, was bound by the statutory language.

Accordingly, we affirm the judgment of the circuit court of Cook County.

? Case Questions

1. Is it possible the defendant did not know his LLC had been involuntarily dissolved because it failed to file its required annual report? Should he have known it was dissolved?
2. If Topel's business had been a corporation, he would not have had insulation from liability for postdissolution contracts—he would have been liable. Is the result here equitable? Is it fraud?
3. Seven months after the LLC's existence was terminated by the state, the defendant hired a number of employees, did not pay them, and then avoided liability under the LLC shield. How else could the court have ruled here? It is possible that the legislature's intent was simply to eliminate compulsory piercing (see Chapter 21 under corporate law principles and leave the question of LLC piercing to the courts. If so was the court's decision was correct? The current LLC act language is similar to the Model Business Corporation Act, which surely permits piercing (see Chapter 21).

More Liability Issues in LLCs

Campbell v. Lichtenfels

2007 WL 447919 (Conn. Super. 2007)

This case concerns the aftermath of the dissolution of the parties' law practice. Following a hearing on January 2 and 3, 2007, this court issued a memorandum of decision on January 5, 2007 granting the plaintiff a prejudgment remedy in the amount of $15,782.01. The plaintiff has now moved for reargument, contending that the court improperly considered as a setoff one-half of a malpractice settlement paid personally by the defendant, which sum the court found to be a debt of a partnership. [The defendant was sued for malpractice by a third party; he paid the entire claim personally and when the law firm dissolved, the plaintiff's share from the liquidated assets was reduced by one-half to account for the amount the defendant had paid.]

In support of his motion to reargue, the plaintiff relies on General Statutes Sec. 34-427(c) and, in that motion, italicizes those portions which he believes apply to his request for reargument. That section states (with emphasis as supplied in the plaintiff's motion) that:

a partner in a registered limited liability partnership is not liable directly or indirectly, *including by way of indemnification, contribution or otherwise*, for any debts, obligations and liabilities of or chargeable *to the partnership or another partner* or partners, *whether arising in* contract, *tort*, or otherwise, arising in the course of the partnership business while the partnership is a registered limited liability partnership. (emphasis in original)

While italicizing the phases that appear to suit his purposes, the plaintiff completely ignores the most important phrase: "a partner in a registered limited liability partnership." At the hearing, neither party presented any evidence at the hearing that tended to prove that the nature of the business relationship between the parties was that of a "registered limited liability partnership." To the contrary, the testimony presented at the hearing revealed that the parties had a general partnership in which they had orally agreed to share profits and losses equally and that they never signed a partnership agreement. There was certainly no testimony or tangible evidence to the effect that the partnership had filed "a certificate of limited liability partnership with the Secretary of the State, stating the name of the partnership, which shall conform to the requirements of [the statute]; the address of its principal office;…a brief statement of the business in which the partnership engages; any other matters the partnership may determine to include; and that the partnership therefore applies for status as a registered limited liability partnership." [Citation]

It is true that certain of the exhibits, such as copies of checks and letters written on the law firm letterhead, refer to the firm as "Campbell and Lichtenfels, LLP." These exhibits, however, were not offered for the purpose of establishing the partnership's character, and merely putting the initials "LLP" on checks and letterhead is not, in and of itself, proof of having met the statutory requirements for registration as a limited liability partnership. The key to establishing entitlement to the protections offered by [the limited liability partnership statute] is proof that the partnership has filed "a certificate of limited liability partnership with the Secretary of the State," and the plaintiff presented no such evidence to the court.

Because the evidence presented at the hearing does not support a claim that the nature of the relationship between the parties to this case was that of partners in a registered limited liability partnership, the provisions of [the limited liability partnership statute] do not apply. Rather, this partnership is governed by the provisions of [the Uniform Partnership Act] which states: "Except as otherwise provided…all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the

claimant or provided by law." Because there has been no evidence that this partnership falls within [any exceptions] the court finds Campbell and Lichtenfels to have been a general partnership in which the plaintiff shares the liability for the malpractice claim, even if he was not the partner responsible for the alleged negligence that led to that claim.

The plaintiff correctly points out that reargument is appropriate when the court has "overlooked" a "…principle of law which would have a controlling effect…" on the outcome of the case at hand. [Citation] The principle of law now raised by the plaintiff was "overlooked" by the court at the time of the hearing for two good reasons. First, it was not brought to the court's attention at the time of the hearing. Second, and more importantly, the plaintiff presented no evidence that would have supported the claim that the principle of law in question, namely the provisions of [the limited liability partnership] was applicable to the facts of this case. Because the provisions of [that statute] are inapplicable, they are quite obviously not "controlling." The principle of law which does control this issue is found in [general partnership law] and that principle makes the plaintiff liable for his share of the malpractice settlement, as the court has previously found. The motion for reargument is therefore denied.

? Case Questions

1. If the parties had been operating as a limited liability partnership, how would that have changed the result?
2. Why did the court find that there was no limited liability partnership?
3. How does general partnership law treat a debt by one partner incurred in the course of partnership business?
4. Here, as in the case in Section 20.4.2 "Liability Issues in LLCs", there really is no inequitable result. Why is this true?

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13.6: Summary and Exercises

Summary

Between partnerships and corporations lie a variety of hybrid business forms: limited partnerships, sub-S corporations, limited liability companies, limited liability partnerships, and limited liability limited partnerships. These business forms were invented to achieve, as much as possible, the corporate benefits of limited liability, centralized control, and easy transfer of ownership interest with the tax treatment of a partnership.

Limited partnerships were recognized in the early twentieth century and today are governed mostly by the Uniform Limited Partnership Act (ULPA-1985 or ULPA-2001). These entities, not subject to double taxation, are composed of one or more general partners and one or more limited partners. The general partner controls the firm and is liable like a partner in a general partnership (except under ULPA-2001 liability is limited); the limited partners are investors and have little say in the daily operations of the firm. If they get too involved, they lose their status as limited partners (except this is not so under ULPA-2001). The general partner, though, can be a corporation, which finesses the liability problem. A limited partnership comes into existence only when a certificate of limited partnership is filed with the state.

In the mid-twentieth century, Congress was importuned to allow small corporations the benefit of pass-through taxation. It created the sub-S corporation (referring to a section of the IRS code). It affords the benefits of taxation like a partnership and limited liability for its members, but there are several inconvenient limitations on how sub-S corporations can be set up and operate.

The 1990s saw the limited liability company become the entity of choice for many businesspeople. It deftly combines limited liability for all owners—managers and nonmanagers—with pass-through taxation and has none of the restrictions perceived to hobble the sub-S corporate form. Careful crafting of the firm's bylaws and operating certificate allow it to combine the best of all possible business forms. There remained, though, one fly in the ointment: most states did not allow professionals to form limited liability companies (LLCs).

This last barrier was hurtled with the development of the limited liability partnership. This form, though mostly governed by partnership law, eschews the vicarious liability of nonacting partners for another's torts, malpractice, or partnership breaches of contract. The extent to which such exoneration from liability presents a moral hazard—allowing bad actors to escape their just liability—is a matter of concern.

Having polished off liability for all owners with the LLC and the LLP, the next logical step occurred when eyes returned to the venerable limited partnership. The invention of the limited liability limited partnership in ULPA-2001 not only abolished the "control test" that made limited partners liable if they got too involved in the firm's operations but also eliminated the general partner's liability.

Comparison of Business Organization Forms

Type of Business Form	Formation and Ownership Rules	Funding	Management	Liability	Taxes	Dissolution
Limited partnership	Formal filing of articles of partnership; unlimited number of general and limited partners	General and limited partners contribute capital	General partner	General partner personally liable; limited partners to extent of contribution Under ULPA-2001, the general partner has limited liability.	Flow-through as in partnership	Death or termination of general partner, unless otherwise agreed
S corporation	Formal filing of articles of incorporation; up to 100 shareholders allowed but only one class of stock	Equity (sell stock) or debt funding (issue bonds); members share profits and losses	Board of directors, officers	Owners not personally liable absent piercing corporate veil (see Chapter 21)	Flow-through as in partnership	Only if limited duration or shareholders vote to dissolve
Limited liability company	Formal filing of articles of organization; unlimited "members"	Members make capital contributions, share profits and losses	Member managed or manager managed	Limited liability	Flow-through as in partnership.	Upon death or bankruptcy, unless otherwise agreed
Limited liability partnership (LLP)	Formal filing of articles of LLP	Members make capital contributions, share profits and losses	All partners or delegated to managing partner	Varies, but liability is generally on partnership; nonacting partners have limited liability	Flow-through as in partnership	Upon death or bankruptcy, unless otherwise agreed
Limited liability limited partnership (LLLP)	Formal filing of articles of LLP; choosing LLLP form	Same as above	Same as above	Liability on general partner abolished: all members have limited liability	Flow-through as in partnership	Same as above

Exercises

1. Yolanda and Zachary decided to restructure their small bookstore as a limited partnership, called "Y to Z's Books, LP." Under their new arrangement, Yolanda contributed a new infusion of $300; she was named the general partner. Zachary contributed $300 also, and he was named the limited partner: Yolanda was to manage the store on Monday, Wednesday, and Friday, and Zachary to manage it on Tuesday, Thursday, and Saturday. Y to Z Books, LP failed to pay $800 owing to Vendor. Moreover, within a few weeks, Y to Z's Books became insolvent. Who is liable for the damages to Vendor?
2. What result would be obtained in Exercise 1 if Yolanda and Zachary had formed a limited liability company?
3. Suppose Yolanda and Zachary had formed a limited liability partnership. What result would be obtained then?
4. Jacobsen and Kelly agreed to form an LLC. They filled out the appropriate paperwork and mailed it with their check to the secretary of state's office. However, they made a mistake: instead of sending it to "Boston, MA"—Boston, Massachusetts—they sent it to "Boston, WA"—Boston, Washington. There is a town in Washington State called "Little Boston" that is part of an

isolated Indian reservation. The paperwork got to Little Boston but then was much delayed. After two weeks, Jacobsen and Kelly figured the secretary of state in Boston, MA, was simply slow to respond. They began to use their checks, business cards, and invoices labeled "Jacobsen and Kelly, LLC." They made a contract to construct a wind turbine for Pablo; Kelly did the work but used guy wires that were too small to support the turbine. During a modest wind a week after the turbine's erection, it crashed into Pablo's house. The total damages exceeded $35,000. Pablo discovered Jacobsen and Kelly's LLC was defectively created and sought judgment against them personally. May Pablo proceed against them both personally?

5. Holden was the manager of and a member of Frost LLLP, an investment firm. In that capacity, he embezzled $30,000 from one of the firm's clients, Backus. Backus sued the firm and Holden personally, but the latter claimed he was shielded from liability by the firm. Is Holden correct?
6. Bellamy, Carlisle, and Davidson formed a limited partnership. Bellamy and Carlisle were the general partners and Davidson the limited partner. They contributed capital in the amounts of $100,000, $100,000, and $200,000, respectively, but then could not agree on a profit-sharing formula. At the end of the first year, how should they divide their profits?

SELF CHECK QUESTIONS

1. Peron and Quinn formed P and Q Limited Partnership. Peron made a capital contribution of $20,000 and became a general partner. Quinn made a capital contribution of $10,000 and became a limited partner. At the end of the first year of operation, a third party sued the partnership and both partners in a tort action. What is the potential liability of Peron and Quinn, respectively?
    1. $20,000 and $10,000
    2. $20,000 and $0
    3. unlimited and $0
    4. unlimited and $10,000
    5. unlimited and unlimited
2. A limited partnership
    1. comes into existence when a certificate of partnership is filed
    2. always provides limited liability to an investor
    3. gives limited partners a say in the daily operation of the firm
    4. is not likely to be the business form of choice if a limited liability limited partnership option is available
    5. two of these (specify)
3. Puentes is a limited partner of ABC, LP. He paid $30,000 for his interest and he also loaned the firm $20,000. The firm failed. Upon dissolution and liquidation,
    1. Puentes will get his loan repaid pro rata along with other creditors.
    2. Puentes will get repaid, along with other limited partners, in respect to his capital and loan after all other creditors have been paid.
    3. if any assets remain, the last to be distributed will be the general partners' profits.
    4. if Puentes holds partnership property as collateral, he can resort to it to satisfy his claim if partnership assets are insufficient to meet creditors' claims.
4. Reference to "moral hazard" in conjunction with hybrid business forms gets to what concern?
    1. that general partners in a limited partnership will run the firm for their benefit, not the limited partners' benefit
    2. that the members of a limited liability company or limited liability partnership will engage in activities that expose themselves to potential liability
    3. that the trend toward limited liability gives bad actors little incentive to behave ethically because the losses caused by their behavior are mostly not borne by them
    4. that too few modern professional partnerships will see any need for malpractice insurance
5. One of the advantages to the LLC form over the sub-S form is
    1. in the sub-S form, corporate profits are effectively taxed twice.
    2. the sub-S form does not provide "full-shield" insulation of liability for its members.
    3. the LLC cannot have a "manager-manager" form of control, whereas that is common for sub-S corporations.

4. the LLC form requires fewer formalities in its operation (minutes, annual meetings, etc.).

AnswerS

1. d
2. e (that is, a and d)
3. d (Choice a is wrong because as a secured creditor Puentes can realize on the collateral without regard to other creditors' payment.)
4. c
5. d

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CHAPTER OVERVIEW

14: Business Law - Corporations

Learning Objectives

After reading this chapter, you should understand the following:

- The historical background of the corporation
- How partnerships compare with corporations
- What the corporation is as a legal entity, and how corporate owners can lose limited liability by certain actions
- How corporations are classified

The corporation is the dominant form of the business enterprise in the modern world. As a legal entity, it is bound by much of the law discussed in the preceding chapters. However, as a significant institutional actor in the business world, the corporation has a host of relationships that have called forth a separate body of law.

14.1: Historical Background

14.2: Partnerships versus Corporations

14.3: The Corporate Veil- The Corporation as a Legal Entity

14.4: Classifications of Corporations

14.5: Corporate Organization

14.6: Effect of Organization

14.7: Cases

14.8: Summary and Exercises

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14.1: Historical Background

Learning Objectives

By the end of this section, you will be able to:

- Comprehend the historical significance of corporate formation.
- Learn about key court decisions and their effect on interstate commerce and corporate formation.
- Become acquainted with how states formed their corporate laws.

A Fixture of Every Major Legal System

Like partnership, the corporation is an ancient concept, recognized in the Code of Hammurabi, and to some degree a fixture in every other major legal system since then. The first corporations were not business enterprises; instead, they were associations for religious and governmental ends in which perpetual existence was a practical requirement. Thus until relatively late in legal history, kings, popes, and jurists assumed that corporations could be created only by political or ecclesiastical authority and that corporations were creatures of the state or church. By the seventeenth century, with feudalism on the wane and business enterprise becoming a growing force, kings extracted higher taxes and intervened more directly in the affairs of businesses by refusing to permit them to operate in corporate form except by royal grant. This came to be known as the concession theory, because incorporation was a concession from the sovereign.

The most important concessions, or charters, were those given to the giant foreign trading companies, including the Russia Company (1554), the British East India Company (1600), Hudson's Bay Company (1670, and still operating in Canada under the name "the Bay"), and the South Sea Company (1711). These were joint-stock companies—that is, individuals contributed capital to the enterprise, which traded on behalf of all the stockholders. Originally, trading companies were formed for single voyages, but the advantages of a continuing fund of capital soon became apparent. Also apparent was the legal characteristic that above all led shareholders to subscribe to the stock: limited liability. They risked only the cash they put in, not their personal fortunes.

Some companies were wildly successful. The British East India Company paid its original investors a fourfold return between 1683 and 1692. But perhaps nothing excited the imagination of the British more than the discovery of gold bullion aboard a Spanish shipwreck; 150 companies were quickly formed to salvage the sunken Spanish treasure. Though most of these companies were outright frauds, they ignited the search for easy wealth by a public unwary of the risks. In particular, the South Sea Company promised the sun and the moon: in return for a monopoly over the slave trade to the West Indies, it told an enthusiastic public that it would retire the public debt and make every person rich.

In 1720, a fervor gripped London that sent stock prices soaring. Beggars and earls alike speculated from January to August; and then the bubble burst. Without considering the ramifications, Parliament had enacted the highly restrictive Bubble Act, which was supposed to do away with unchartered **joint-stock** companies. When the government prosecuted four companies under the act for having fraudulently obtained charters, the public panicked and stock prices came tumbling down, resulting in history's first modern financial crisis.

As a consequence, corporate development was severely retarded in England. Distrustful of the chartered company, Parliament issued few corporate charters, and then only for public or quasi-public undertakings, such as transportation, insurance, and banking enterprises. Corporation law languished: William Blackstone devoted less than 1 percent of his immensely influential *Commentaries on the Law of England* (1765) to corporations and omitted altogether any discussion of limited liability. In *The Wealth of Nations* (1776), Adam Smith doubted that the use of corporations would spread. England did not repeal the Bubble Act until 1825, and then only because the value of true incorporation had become apparent from the experience of its former colonies.

US Corporation Formation

The United States remained largely unaffected by the Bubble Act. Incorporation was granted only by special acts of state legislatures, even well into the nineteenth century, but many such acts were passed. Before the Revolution, perhaps fewer than a dozen business corporations existed throughout the thirteen colonies. During the 1790s, two hundred businesses were incorporated, and their numbers swelled thereafter. The theory that incorporation should not be accomplished except through special legislation

began to give way. As industrial development accelerated in the mid-1800s, it was possible in many states to incorporate by adhering to the requirements of a general statute. Indeed, by the late nineteenth century, all but three states constitutionally *forbade* their legislatures from chartering companies through special enactments.

The US Supreme Court contributed importantly to the development of corporate law. In *Gibbons v. Ogden*,*Gibbons v. Ogden*, 22 U.S. 1 (1824). a groundbreaking case, the Court held that the Commerce Clause of the US Constitution (Article I, Section 8, Clause 3) granted Congress the power to regulate interstate commerce. However, in *Paul v. Virginia*,*Paul v. Virginia*, 75 U.S. 168 (1868). the Court said that a state could prevent corporations not chartered there—that is, **out-of-state or**foreign corporations—from engaging in what it considered the local, and not interstate, business of issuing insurance policies. The inference made by many was that states could not bar foreign corporations engaged in *interstate* business from their borders.

This decision brought about a competition in corporation laws. The early general laws had imposed numerous restrictions. The breadth of corporate enterprise was limited, ceilings were placed on total capital and indebtedness, incorporators were required to have residence in the state, the duration of the company often was not perpetual but was limited to a term of years or until a particular undertaking was completed, and the powers of management were circumscribed. These restrictions and limitations were thought to be necessary to protect the citizenry of the chartering legislature's own state. But once it became clear that companies chartered in one state could operate in others, states began in effect to "sell" incorporation for tax revenues.

New Jersey led the way in 1875 with a general incorporation statute that greatly liberalized the powers of management and lifted many of the former restrictions. The Garden State was ultimately eclipsed by Delaware, which in 1899 enacted the most liberal corporation statute in the country, so that to the present day there are thousands of "Delaware corporations" that maintain no presence in the state other than an address on file with the secretary of state in Dover.

During the 1920s, the National Conference of Commissioners on Uniform State Laws drafted a Uniform Business Corporation Act, the final version of which was released in 1928. It was not widely adopted, but it did provide the basis during the 1930s for revisions of some state laws, including those in California, Illinois, Michigan, Minnesota, and Pennsylvania. By that time, in the midst of the Great Depression, the federal government for the first time intruded into corporate law in a major way by creating federal agencies, most notably the Securities and Exchange Commission in 1934, with power to regulate the interstate issuance of corporate stock.

Corporate Law Today

Following World War II, most states revised their general corporation laws. A significant development for states was the preparation of the Model Business Corporation Act by the American Bar Association's Committee on Corporate Laws. About half of the states have adopted all or major portions of the act. The 2005 version of this act, the Revised Model Business Corporation Act (RMBCA), will be referred to throughout our discussion of corporation law.

Key Takeaway

Corporations have their roots in political and religious authority. The concept of limited liability and visions of financial rewards fueled the popularity of joint-stock companies, particularly trading companies, in late-seventeenth- and early eighteenth-century England. The English Parliament successfully enacted the Bubble Act in 1720 to curb the formation of these companies; the restrictions weren't loosened until over one hundred years later, after England viewed the success of corporations in its former colonies. Although early corporate laws in the United States were fairly restrictive, once states began to "sell" incorporation for tax revenues, the popularity of liberal and corporate-friendly laws caught on, especially in Delaware beginning in 1899. A corporation remains a creature of the state—that is, the state in which it is incorporated. Delaware remains the state of choice because more corporations are registered there than in any other state.

Exercises

1. If the English Parliament had not enacted the Bubble Act in 1720, would the "bubble" have burst? If so, what would have been the consequences to corporate development?
2. What were some of the key components of early US corporate laws? What was the rationale behind these laws?
3. In your opinion, what are some of the liberal laws that attract corporations to Delaware?

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14.2: Partnerships versus Corporations

Learning Objectives

By the end of this section, you will be able to:

- Distinguish basic aspects of partnership formation from those of corporate formation.
- Explain ownership and control in partnerships and in publicly held and closely held corporations.
- Know how partnerships and corporations are taxed.

Let us assume that three people have already formed a partnership to run a bookstore business. Bob has contributed $80,000. Carol has contributed a house in which the business can lawfully operate. Ted has contributed his services; he has been managing the bookstore, and the business is showing a slight profit. A friend has been telling them that they ought to incorporate. What are the major factors they should consider in reaching a decision?

Ease of Formation

Partnerships are easy to form. If the business is simple enough and the partners are few, the agreement need not even be written down. Creating a corporation is more complicated because formal documents must be placed on file with public authorities.

Ownership and Control

All general partners have equal rights in the management and conduct of the business. By contrast, ownership and control of corporations are, in theory, separated. In the publicly held corporation, which has many shareholders, the separation is real. Ownership is widely dispersed because millions of shares are outstanding and it is rare that any single shareholder will own more than a tiny percentage of stock. It is difficult under the best of circumstances for shareholders to exert any form of control over corporate operations. However, in the closely held corporation, which has few shareholders, the officers or senior managers are usually also the shareholders, so the separation of ownership and control may be less pronounced or even nonexistent.

Transferability of Interests

Transferability of an interest in a partnership is a problem because a transferee cannot become a member unless all partners consent. The problem can be addressed and overcome in the partnership agreement. Transfer of interest in a corporation, through a sale of stock, is much easier; but for the stock of a small corporation, there might not be a market or there might be contractual restrictions on transfer.

Financing

Partners have considerable flexibility in financing. They can lure potential investors by offering interests in profits and, in the case of general partnerships, control. Corporations can finance by selling freely transferable stock to the public or by incurring debt. Different approaches to the financing of corporations are discussed in “Legal Aspects of Corporate Finance”.

Taxation

The partnership is a conduit for income and is not taxed as a separate entity. Individual partners are taxed, and although limited by the 1986 Tax Reform Act, they can deduct partnership losses. Corporate earnings, on the other hand, are subject to double taxation. The corporation is first taxed on its own earnings as an entity. Then, when profits are distributed to shareholders in the form of dividends, the shareholders are taxed again. (A small corporation, with no more than one hundred shareholders, can elect S corporation status. Because S corporations are taxed as partnerships, they avoid double taxation.) However, incorporating brings several tax benefits. For example, the corporation can take deductions for life, medical, and disability insurance coverage for its employees, whereas partners or sole proprietors cannot.

Key Takeaway

Partnerships are easier to form than corporations, especially since no documents are required. General partners share both ownership and control, but in publicly held corporations, these functions are separated. Additional benefits for a partnership include

flexibility in financing, single taxation, and the ability to deduct losses. Transfer of interest in a partnership can be difficult if not addressed in the initial agreement, since all partners must consent to the transfer.

Exercises

1. Provide an example of when it would be best to form a partnership, and cite the advantages and disadvantages of doing so.
2. Provide an example of when it would be best to form a corporation, and cite the advantages and disadvantages of doing so.

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14.3: The Corporate Veil- The Corporation as a Legal Entity

Learning Objectives

By the end of this section, you will be able to:

- Know what rights a corporate "person" and a natural person have in common.
- Recognize when a corporate "veil" is pierced and shareholder liability is imposed.
- Identify other instances when a shareholder will be held personally liable.

In comparing partnerships and corporations, there is one additional factor that ordinarily tips the balance in favor of incorporating: the corporation is a legal entity in its own right, one that can provide a "veil" that protects its shareholders from personal liability.

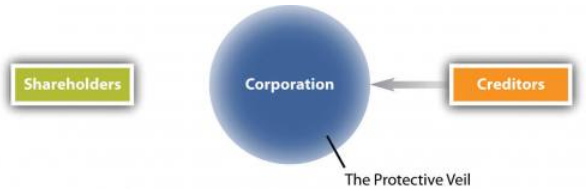


Figure 21.1 The Corporate Veil

This crucial factor accounts for the development of much of corporate law. Unlike the individual actor in the legal system, the corporation is difficult to deal with in conventional legal terms. The business of the sole proprietor and the sole proprietor herself are one and the same. When a sole proprietor makes a decision, she risks her own capital. When the managers of a corporation take a corporate action, they are risking the capital of others—the shareholders. Thus accountability is a major theme in the system of law constructed to cope with legal entities other than natural persons.

The Basic Rights of the Corporate "Person"

To say that a corporation is a "person" does not automatically describe what its rights are, for the courts have not accorded the corporation every right guaranteed a natural person. Yet the Supreme Court recently affirmed in *Citizens United v. Federal Election Commission* (2010) that the government may not suppress the First Amendment right of political speech because the speaker is a corporation rather than a natural person. According to the Court, "No sufficient governmental interest justifies limits on the political speech of nonprofit or for-profit corporations."*Citizens United v. Federal Election Commission*, 558 U.S. ___ (2010).

The courts have also concluded that corporations are entitled to the essential constitutional protections of due process and equal protection. They are also entitled to Fourth Amendment protection against unreasonable search and seizure; in other words, the police must have a search warrant to enter corporate premises and look through files. Warrants, however, are not required for highly regulated industries, such as those involving liquor or guns. The Double Jeopardy Clause applies to criminal prosecutions of corporations: an acquittal cannot be appealed nor can the case be retried. For purposes of the federal courts' diversity jurisdiction, a corporation is deemed to be a citizen of both the state in which it is incorporated and the state in which it has its principal place of business (often, the corporate "headquarters").

Until relatively recently, few cases had tested the power of the state to limit the right of corporations to spend their own funds to speak the "corporate mind." Most cases involving corporate free speech address advertising, and few states have enacted laws that directly impinge on the freedom of companies to advertise. But those states that have done so have usually sought to limit the ability of corporations to sway voters in public referenda. In 1978, the Supreme Court finally confronted the issue head on in *First National Bank of Boston v. Bellotti* (Section 21.7.1 "Limiting a Corporation's First Amendment Rights"). The ruling in *Bellotti* was reaffirmed by the Supreme Court in *Citizens United v. Federal Election Commission*. In *Citizens United*, the Court struck down the part of the McCain-Feingold ActThe Bipartisan Campaign Reform Act of 2002 (BCRA, McCain–Feingold Act, Pub.L. 107-155, 116 Stat. 81, enacted March 27, 2002, H.R. 2356). that prohibited all corporations, both for-profit and not-for-profit, and unions from broadcasting "electioneering communications."

Absence of Rights

Corporations lack certain rights that natural persons possess. For example, corporations do not have the privilege against self-incrimination guaranteed for natural persons by the Fifth and Fourteenth Amendments. In any legal proceeding, the courts may force a corporation to turn over incriminating documents, even if they also incriminate officers or employees of the corporation. As we explore in Chapter 25, corporations are not citizens under the Privileges and Immunities Clause of the Constitution, so that the states can discriminate between domestic and foreign corporations. And the corporation is not entitled to federal review of state criminal convictions, as are many individuals.

Piercing the Corporate Veil

Given the importance of the corporate entity as a veil that limits shareholder liability, it is important to note that in certain circumstances, the courts may reach beyond the wall of protection that divides a corporation from the people or entities that exist behind it. This is known as piercing the corporate veil, and it will occur in two instances: (1) when the corporation is used to commit a fraud or an injustice and (2) when the corporation does not act as if it were one.

Fraud

The Felsenthal Company burned to the ground. Its president, one of the company's largest creditors and also virtually its sole owner, instigated the fire. The corporation sued the insurance company to recover the amount for which it was insured. According to the court in the Felsenthal case, "The general rule of law is that the willful burning of property by a stockholder in a corporation is not a defense against the collection of the insurance by the corporation, and…the corporation cannot be prevented from collecting the insurance because its agents willfully set fire to the property without the participation or authority of the corporation or of all of the stockholders of the corporation."*D. I. Felsenthal Co. v. Northern Assurance Co., Ltd.*, 284 Ill. 343, 120 N.E. 268 (1918). But because the fire was caused by the beneficial owner of "practically all" the stock, who also "has the absolute management of [the corporation's] affairs and its property, and is its president," the court refused to allow the company to recover the insurance money; allowing the company to recover would reward fraud.*Felsenthal Co. v. Northern Assurance Co., Ltd.*, 120 N.E. 268 (Ill. 1918).

Failure to Act as a Corporation

In other limited circumstances, individual stockholders may also be found personally liable. Failure to follow corporate formalities, for example, may subject stockholders to personal liability. This is a special risk that small, especially one-person, corporations run. Particular factors that bring this rule into play include inadequate capitalization, omission of regular meetings, failure to record minutes of meetings, failure to file annual reports, and commingling of corporate and personal assets. Where these factors exist, the courts may look through the corporate veil and pluck out the individual stockholder or stockholders to answer for a tort, contract breach, or the like. The classic case is the taxicab operator who incorporates several of his cabs separately and services them through still another corporation. If one of the cabs causes an accident, the corporation is usually "judgment proof" because the corporation will have few assets (practically worthless cab, minimum insurance). The courts frequently permit plaintiffs to proceed against the common owner on the grounds that the particular corporation was inadequately financed.

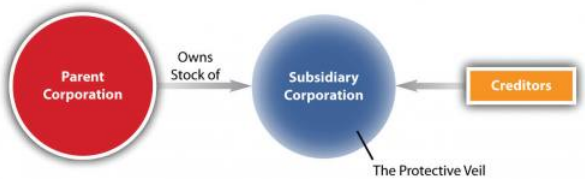


Figure 21.2 The Subsidiary as a Corporate Veil

When a corporation owns a subsidiary corporation, the question frequently arises whether the subsidiary is acting as an independent entity (see Figure 21.2). The Supreme Court addressed this question of derivative versus direct liability of the corporate parent vis-à-vis its subsidiary in *United States v. Bestfoods*, (see Section 21.7.2 "Piercing the Corporate Veil").

Other Types of Personal Liability

Even when a corporation is formed for a proper purpose and is operated as a corporation, there are instances in which individual shareholders will be personally liable. For example, if a shareholder involved in company management commits a tort or enters into a contract in a personal capacity, he will remain personally liable for the consequences of his actions. In some states, statutes give employees special rights against shareholders. For example, a New York statute permits employees to recover wages, salaries, and debts owed them by the company from the ten largest shareholders of the corporation. (Shareholders of public companies whose stock is traded on a national exchange or over the counter are exempt.) Likewise, federal law permits the IRS to recover from the "responsible persons" any withholding taxes collected by a corporation but not actually paid over to the US Treasury.

Key Takeaway

Corporations have some of the legal rights of a natural person. They are entitled to the constitutional protections of due process and equal protection, Fourth Amendment protection against unreasonable search and seizure, and First Amendment protection of free speech and expression. For purposes of the federal courts' diversity jurisdiction, a corporation is deemed to be a citizen of both the state in which it is incorporated and the state in which it has its principal place of business. However, corporations do not have the privilege against self-incrimination guaranteed for natural persons by the Fifth and Fourteenth Amendments. Further, corporations are not free from liability. Courts will pierce the corporate veil and hold a corporation liable when the corporation is used to perpetrate fraud or when it fails to act as a corporation.

Exercises

1. Do you think that corporations should have rights similar to those of natural persons? Should any of these rights be curtailed?
2. What is an example of speaking the "corporate mind"?
3. If Corporation BCD's president and majority stockholder secretly sells all of his stock before resigning a few days later, and the corporation's unexpected change in majority ownership causes the share price to plummet, do corporate stockholders have a cause of action? If so, under what theory?

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14.4: Classifications of Corporations

Learning Objectives

By the end of this section, you will be able to:

- Distinguish the "public," or municipal, corporation from the publicly held corporation.
- Explain how the tax structure for professional corporations evolved.
- Define the two types of business corporations.

Nonprofit Corporations

One of the four major classifications of corporations is the nonprofit corporation (also called not-for-profit corporation). It is defined in the American Bar Association's Model Non-Profit Corporation Act as "a corporation no part of the income of *which* is distributable to its members, directors or officers." Nonprofit corporations may be formed under this law for charitable, educational, civil, religious, social, and cultural purposes, among others.

Public Corporations

The true public corporation is a governmental entity. It is often called a municipal corporation, to distinguish it from the publicly held corporation, which is sometimes also referred to as a "public" corporation, although it is in fact private (i.e., it is not governmental). Major cities and counties, and many towns, villages, and special governmental units, such as sewer, transportation, and public utility authorities, are incorporated. These corporations are not organized for profit, do not have shareholders, and operate under different statutes than do business corporations.

Professional Corporations

Until the 1960s, lawyers, doctors, accountants, and other professionals could not practice their professions in corporate form. This inability, based on a fear of professionals' being subject to the direction of the corporate owners, was financially disadvantageous. Under the federal income tax laws then in effect, corporations could establish far better pension plans than could the self-employed. During the 1960s, the states began to let professionals incorporate, but the IRS balked, denying them many tax benefits. In 1969, the IRS finally conceded that it would tax a professional corporation just as it would any other corporation, so that professionals could, from that time on, place a much higher proportion of tax-deductible income into a tax-deferred pension. That decision led to a burgeoning number of professional corporations.

Business Corporations

The Two Types

It is the business corporation proper that we focus on in this unit. There are two broad types of business corporations: publicly held (or public) and closely held (or close or private) corporations. Again, both types are private in the sense that they are not governmental.

The publicly held corporation is one in which stock is widely held or available for wide public distribution through such means as trading on a national or regional stock exchange. Its managers, if they are also owners of stock, usually constitute a small percentage of the total number of shareholders and hold a small amount of stock relative to the total shares outstanding. Few, if any, shareholders of public corporations know their fellow shareholders.

By contrast, the shareholders of the closely held corporation are fewer in number. Shares in a closely held corporation could be held by one person, and usually by no more than thirty. Shareholders of the closely held corporation often share family ties or have some other association that permits each to know the others.

Though most closely held corporations are small, no economic or legal reason prevents them from being large. Some are huge, having annual sales of several billion dollars each. Roughly 90 percent of US corporations are closely held.

The giant publicly held companies with more than $1 billion in assets and sales, with initials such as IBM and GE, constitute an exclusive group. Publicly held corporations outside this elite class fall into two broad (nonlegal) categories: those that are quoted

on stock exchanges and those whose stock *is* too widely dispersed to be called closely held but is not traded on exchanges.

Key Takeaway

There are four major classifications of corporations: (1) nonprofit, (2) municipal, (3) professional, and (4) business. Business corporations are divided into two types, publicly held and closely held corporations.

Exercises

1. Why did professionals, such as doctors, lawyers, and accountants, wait so long to incorporate?
2. Distinguish a publicly held corporation from a closely held one.
3. Are most corporations in the US publicly or closely held? Are closely held corporations subject to different provisions than publicly held ones?

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14.5: Corporate Organization

Learning Objectives

By the end of this section, you will be able to:

- Recognize the steps to issue a corporate charter.
- Know the states' rights in modifying a corporate charter.
- Discuss factors to consider in selecting a state in which to incorporate.
- Explain the functions and liability of a promoter.
- Understand the business and legal requirements in executing and filing the articles of incorporation.

As discussed in Section 21.4, corporate status offers companies many protections. If the owners of a business decide to incorporate after weighing the pros and cons of incorporation, they need to take the steps explained in this section.

The Corporate Charter

Function of the Charter

The ultimate goal of the incorporation process is issuance of a corporate charter. The term used for the document varies from state to state. Most states call the basic document filed in the appropriate public office the "articles of incorporation" or "certificate of incorporation," but there are other variations. There is no legal significance to these differences in terminology.

Chartering is basically a state prerogative. Congress has chartered several enterprises, including national banks (under the National Banking Act), federal savings and loan associations, national farm loan associations, and the like, but virtually all business corporations are chartered at the state level.

Originally a legislative function, chartering is now an administrative function in every state. The secretary of state issues the final indorsement to the articles of incorporation, thus giving them legal effect.

Charter as a Contract

The charter is a contract between the state and the corporation. Under the Contracts Clause of Article I of the Constitution, no state can pass any law "impairing the obligation of contracts." In 1816, the question arose whether a state could revoke or amend a corporate charter once granted. The corporation in question was Dartmouth College. The New Hampshire legislature sought to turn the venerable private college, operating under an old royal charter, into a public institution by changing the membership of its board. The case wound up in the Supreme Court. Chief Justice John Marshall ruled that the legislature's attempt was unconstitutional, because to amend a charter is to impair a contract.*Trustees of Dartmouth College v. Woodward*, 17 U.S. 518 (1819).

This decision pleased incorporators because it implied that once a corporation had been created, the state could never modify the powers it had been granted. But, in addition, the ruling seemed to favor monopolies. The theory was that by granting a charter to, say, a railroad corporation, the state was barred from creating any further railroad corporations. Why? Because, the lawyers argued, a competitor would cut into the first company's business, reducing the value of the charter, hence impairing the contract. Justice Joseph Story, concurring in the *Dartmouth* case, had already suggested the way out for the states: "If the legislature mean to claim such an authority [to alter or amend the charter], it must be reserved in the grant. The charter of Dartmouth College contains no such reservation.…" The states quickly picked up on Justice Story's suggestion and wrote into the charter explicit language giving legislatures the authority to modify corporations' charters at their pleasure. So the potential immutability of corporate charters had little practical chance to develop.

Selection of a State

Where to Charter

Choosing the particular venue in which to incorporate is the first critical decision to be made after deciding to incorporate. Some corporations, though headquartered in the United States, choose to incorporate offshore to take advantage of lenient taxation laws.

Advantages of an offshore corporation include not only lenient tax laws but also a great deal of privacy as well as certain legal protections. For example, the names of the officers and directors can be excluded from documents filed. In the United States, over half of the *Fortune* 500 companies hold Delaware charters for reasons related to Delaware's having a lower tax structure, a favorable business climate, and a legal system—both its statutes and its courts—seen as being up to date, flexible, and often probusiness. Delaware's success has led other states to compete, and the political realities have caused the Revised Model Business Corporation Act (RMBCA), which was intentionally drafted to balance the interests of all significant groups (management, shareholders, and the public), to be revised from time to time so that it is more permissive from the perspective of management.

Why Choose Delaware?

Delaware remains the most popular state in which to incorporate for several reasons, including the following: (1) low incorporation fees; (2) only one person is needed to serve the incorporator of the corporation; the RMBC requires three incorporators; (3) no minimum capital requirement; (4) favorable tax climate, including no sales tax; (5) no taxation of shares held by nonresidents; and (5) no corporate income tax for companies doing business outside of Delaware. In addition, Delaware's Court of Chancery, a court of equity, is renowned as a premier business court with a well-established body of corporate law, thereby affording a business a certain degree of predictability in judicial decision making.

The Promoter

Functions

Once the state of incorporation has been selected, it is time for promoters, the midwives of the enterprise, to go to work. Promoters are the individuals who take the steps necessary to form the corporation, and they often will receive stock in exchange for their efforts. They have four principal functions: (1) to seek out or discover business opportunities, (2) to raise capital by persuading investors to sign stock subscriptions, (3) to enter into contracts on behalf of the corporation to be formed, (4) and to prepare the articles of incorporation.

Promoters have acquired an unsavory reputation as fast talkers who cajole investors out of their money. Though some promoters fit this image, it is vastly overstated. Promotion is difficult work often carried out by the same individuals who will manage the business.

Contract Liability

Promoters face two major legal problems. First, they face possible liability on contracts made on behalf of the business before it is incorporated. For example, suppose Bob is acting as promoter of the proposed BCT Bookstore, Inc. On September 15, he enters into a contract with Computogram Products to purchase computer equipment for the corporation to be formed. If the incorporation never takes place, or if the corporation is formed but the corporation refuses to accept the contract, Bob remains liable.

Now assume that the corporation is formed on October 15, and on October 18 it formally accepts all the contracts that Bob signed prior to October 15. Does Bob remain liable? In most states, he does. The ratification theory of agency law will not help in many states that adhere strictly to agency rules, because there was no principal (the corporation) in existence when the contract was made and hence the promoter must remain liable. To avoid this result, Bob should seek an express novation, although in some states, a novation will be implied. The intention of the parties should be stated as precisely as possible in the contract, as the promoters learned in *RKO-Stanley Warner Theatres, Inc. v. Graziano*, (see Section 21.7.3 "Corporate Promoter").

The promoters' other major legal concern is the duty owed to the corporation. The law is clear that promoters owe a fiduciary duty. For example, a promoter who transfers real estate worth $250,000 to the corporation in exchange for $750,000 worth of stock would be liable for $500,000 for breach of fiduciary duty.

Preincorporation Stock Subscriptions

One of the promoter's jobs is to obtain preincorporation stock subscriptions to line up offers by would-be investors to purchase stock in the corporation to be formed. These stock subscriptions are agreements to purchase, at a specified price, a certain number of shares of stock of a corporation, which is to be formed at some point in the future. The contract, however, actually comes into existence *after* formation, once the corporation itself accepts the offer to subscribe. Alice agrees with Bob to invest $10,000 in the BCT Bookstore, Inc. for one thousand shares. The agreement is treated as an offer to purchase. The offer is deemed accepted at the moment the bookstore is incorporated.

The major problem for the corporation is an attempt by subscribers to revoke their offers. A basic rule of contract law is that offers are revocable before acceptance. Under RMBCA, Section 6.20, however, a subscription for shares is irrevocable for six months unless the subscription agreement itself provides otherwise or unless all the subscribers consent to revocation. In many states that have not adopted the model act, the contract rule applies and the offer is always revocable. Other states use various common-law devices to prevent revocation. For example, the subscription by one investor is held as consideration for the subscription of another, so that a binding contract has been formed.

Execution and Filing of the Articles of Incorporation

Once the business details are settled, the promoters, now known as incorporators, must sign and deliver the articles of incorporation to the secretary of state. The articles of incorporation typically include the following: the corporate name; the address of the corporation's initial registered office; the period of the corporation's duration (usually perpetual); the company's purposes; the total number of shares, the classes into which they are divided, and the par value of each; the limitations and rights of each class of shareholders; the authority of the directors to establish preferred or special classes of stock; provisions for preemptive rights; provisions for the regulation of the internal affairs of the corporation, including any provision restricting the transfer of shares; the number of directors constituting the initial board of directors and the names and addresses of initial members; and the name and address of each incorporator. Although compliance with these requirements is largely a matter of filling in the blanks, two points deserve mention.

First, the choice of a name is often critical to the business. Under RMBCA, Section 4.01, the name must include one of the following words (or abbreviations): corporation, company, incorporated, or limited (Corp., Co., Inc., or Ltd.). The name is not allowed to deceive the public about the corporation's purposes, nor may it be the same as that of any other company incorporated or authorized to do business in the state.

These legal requirements are obvious; the business requirements are much harder. If the name is not descriptive of the business or does not anticipate changes in the business, it may have to be changed, and the change can be expensive. For example, when Standard Oil Company of New Jersey changed its name to Exxon in 1972, the estimated cost was over $100 million. (And even with this expenditure, some shareholders grumbled that the new name sounded like a laxative.)

The second point to bear in mind about the articles of incorporation is that drafting the clause stating corporate purposes requires special care, because the corporation will be limited to the purposes set forth. In one famous case, the charter of Cornell University placed a limit on the amount of contributions it could receive from any one benefactor. When Jennie McGraw died in 1881, leaving to Cornell the carillon that still plays on the Ithaca, New York, campus to this day, she also bequeathed to the university her residuary estate valued at more than $1 million. This sum was greater than the ceiling placed in Cornell's charter. After lengthy litigation, the university lost in the US Supreme Court, and the money went to her family.*Cornell University v. Fiske*, 136 U.S. 152 (1890). The dilemma is how to draft a clause general enough to allow the corporation to expand, yet specific enough to prevent it from engaging in undesirable activities.

Some states require the purpose clauses to be specific, but the usual approach is to permit a broad statement of purposes. Section 3.01 of the RMBCA goes one step further in providing that a corporation automatically "has the purpose of engaging in any lawful business" unless the articles specify a more limited purpose. Once completed, the articles of incorporation are delivered to the secretary of state for filing. The existence of a corporation begins once the articles have been filed.

Organizational Meeting of Directors

The first order of business, once the certificate of incorporation is issued, is a meeting of the board of directors named in the articles of incorporation. They must adopt bylaws, elect officers, and transact any other business that may come before the meeting (RMBCA, Section 2.05). Other business would include accepting (ratifying) promoters' contracts, calling for the payment of stock subscriptions, and adopting bank resolution forms, giving authority to various officers to sign checks drawn on the corporation.

Section 10.20 of the RMBCA vests in the directors the power to alter, amend, or repeal the bylaws adopted at the initial meeting, subject to repeal or change by the shareholders. The articles of incorporation may reserve the power to modify or repeal exclusively to the shareholders. The bylaws may contain any provisions that do not conflict with the articles of incorporation or the law of the state.

Typical provisions in the bylaws include fixing the place and time at which annual stockholders' meetings will be held, fixing a quorum, setting the method of voting, establishing the method of choosing directors, creating committees of directors, setting down the method by which board meetings may be called and the voting procedures to be followed, determining the offices to be filled by the directors and the powers with which each officer shall be vested, fixing the method of declaring dividends, establishing a fiscal year, setting out rules governing issuance and transfer of stock, and establishing the method of amending the bylaws.

Section 2.07 of the RMBCA provides that the directors may adopt bylaws that will operate during an emergency. An emergency is a situation in which "a quorum of the corporation's directors cannot readily be assembled because of some catastrophic event."

Key Takeaway

Articles of incorporation represent a corporate charter—that is, a contract between the corporation and the state. Filing these articles, or "chartering," is accomplished at the state level. The secretary of state's final approval gives these articles legal effect. A state cannot change a charter unless it reserves the right when granting the charter.

In selecting a state in which to incorporate, a corporation looks for a favorable corporate climate. Delaware remains the state of choice for incorporation, particularly for publicly held companies. Most closely held companies choose to incorporate in their home states.

Following the state selection, the promoter commences his or her functions, which include entering into contracts on behalf of the corporation to be formed (for which he or she can be held liable) and preparing the articles of incorporation.

The articles of incorporation must include the corporation's name and its corporate purpose, which can be broad. Finally, once the certificate of incorporation is issued, the corporation's board of directors must hold an organizational meeting.

Exercises

1. Does the Contracts Clause of the Constitution, which forbids a state from impeding a contract, apply to corporations?
2. What are some of the advantages of selecting Delaware as the state of incorporation?
3. What are some of the risks that a promoter faces for his or her actions on behalf of the corporation? Can he or she limit these risks?
4. What are the dangers of limiting a corporation's purpose?
5. What is the order of business at the first board of directors' meeting?

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14.6: Effect of Organization

Learning Objectives

By the end of this section, you will be able to:

- Distinguish between a de jure and a de facto corporation.
- Define the doctrine of corporation by estoppel.

De Jure and De Facto Corporations

If promoters meet the requirements of corporate formation, a de jure corporation, considered a legal entity, is formed. Because the various steps are complex, the formal prerequisites are not always met. Suppose that a company, thinking its incorporation has taken place when in fact it hasn't met all requirements, starts up its business. What then? Is everything it does null and void? If three conditions exist, a court might decide that a de facto corporation has been formed; that is, the business will be recognized as a corporation. The state then has the power to force the de facto corporation to correct the defect(s) so that a de jure corporation will be created.

The three traditional conditions are the following: (1) a statute must exist under which the corporation could have been validly incorporated, (2) the promoters must have made a bona fide attempt to comply with the statute, and (3) corporate powers must have been used or exercised.

A frequent cause of defective incorporation is the promoters' failure to file the articles of incorporation in the appropriate public office. The states are split on whether a de facto corporation results if every other legal requirement is met.

Corporation by Estoppel

Even if the incorporators omit important steps, it is still possible for a court, under estoppel principles, to treat the business as a corporation. Assume that Bob, Carol, and Ted have sought to incorporate the BCT Bookstore, Inc., but have failed to file the articles of incorporation. At the initial directors' meeting, Carol turns over to the corporation a deed to her property. A month later, Bob discovers the omission and hurriedly submits the articles of incorporation to the appropriate public office. Carol decides she wants her land back. It is clear that the corporation was not de jure at the time she surrendered her deed, and it was probably not de facto either. Can she recover the land? Under equitable principles, the answer is no. She is estopped from denying the existence of the corporation, because it would be inequitable to permit one who has conducted herself as though there were a corporation to deny its existence in order to defeat a contract into which she willingly entered. As *Cranson v. International Business Machines Corp*. indicates (Section 21.7.4 "De Jure and De Facto Corporations"), the doctrine of corporation by estoppel can also be used by the corporation against one of its creditors.

Key Takeaway

A court will find that a corporation might exist under fact (de facto), and not under law (de jure) if the following conditions are met: (1) a statute exists under which the corporation could have been validly incorporated, (2) the promoters must have made a bona fide attempt to comply with the statute, and (3) corporate powers must have been used or exercised. A de facto corporation may also be found when a promoter fails to file the articles of incorporation. In the alternative, the court may look to estoppel principles to find a corporation.

Exercises

1. What are some of the formal prerequisites to forming a de jure corporation?
2. Are states in agreement over what represents a de facto corporation if a promoter fails to file the articles of incorporation?
3. What is the rationale for corporation by estoppel?

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14.7: Cases

Limiting a Corporation's First Amendment Rights

First National Bank of Boston v. Bellotti

435 U.S. 765 (1978)

MR. JUSTICE POWELL delivered the opinion of the Court.

In sustaining a state criminal statute that forbids certain expenditures by banks and business corporations for the purpose of influencing the vote on referendum proposals, the Massachusetts Supreme Judicial Court held that the First Amendment rights of a corporation are limited to issues that materially affect its business, property, or assets. The court rejected appellants' claim that the statute abridges freedom of speech in violation of the First and Fourteenth Amendments. The issue presented in this context is one of first impression in this Court. We postponed the question of jurisdiction to our consideration of the merits. We now reverse.

The statute at issue, Mass. Gen. Laws Ann., Ch. 55, § 8 (West Supp. 1977), prohibits appellants, two national banking associations and three business corporations, from making contributions or expenditures "for the purpose of…influencing or affecting the vote on any question submitted to the voters, other than one materially affecting any of the property, business or assets of the corporation." The statute further specifies that "[no] question submitted to the voters solely concerning the taxation of the income, property or transactions of individuals shall be deemed materially to affect the property, business or assets of the corporation." A corporation that violates § 8 may receive a maximum fine of $50,000; a corporate officer, director, or agent who violates the section may receive a maximum fine of $10,000 or imprisonment for up to one year, or both. Appellants wanted to spend money to publicize their views on a proposed constitutional amendment that was to be submitted to the voters as a ballot question at a general election on November 2, 1976. The amendment would have permitted the legislature to impose a graduated tax on the income of individuals. After appellee, the Attorney General of Massachusetts, informed appellants that he intended to enforce § 8 against them, they brought this action seeking to have the statute declared unconstitutional.

The court below framed the principal question in this case as whether and to what extent corporations have First Amendment rights. We believe that the court posed the wrong question. The Constitution often protects interests broader than those of the party seeking their vindication. The First Amendment, in particular, serves significant societal interests. The proper question therefore is not whether corporations "have" First Amendment rights and, if so, whether they are coextensive with those of natural persons. Instead, the question must be whether § 8 abridges expression that the First Amendment was meant to protect. We hold that it does. The speech proposed by appellants is at the heart of the First Amendment's protection.

The freedom of speech and of the press guaranteed by the Constitution embraces at the least the liberty to discuss publicly and truthfully all matters of public concern without previous restraint or fear of subsequent punishment. Freedom of discussion, if it would fulfill its historic function in this nation, must embrace all issues about which information is needed or appropriate to enable the members of society to cope with the exigencies of their period. *Thornhill v. Alabama*, 310 U.S. 88, 101-102 (1940).

The referendum issue that appellants wish to address falls squarely within this description. In appellants' view, the enactment of a graduated personal income tax, as proposed to be authorized by constitutional amendment, would have a seriously adverse effect on the economy of the State. The importance of the referendum issue to the people and government of Massachusetts is not disputed. Its merits, however, are the subject of sharp disagreement.

We thus find no support in the First or Fourteenth Amendment, or in the decisions of this Court, for the proposition that speech that otherwise would be within the protection of the First Amendment loses that protection simply because its source is a corporation that cannot prove, to the satisfaction of a court, a material effect on its business or property. The "materially affecting" requirement is not an identification of the boundaries of corporate speech etched by the Constitution itself. Rather, it amounts to an impermissible legislative prohibition of speech based on the identity of the interests that spokesmen may represent in public debate over controversial issues and a requirement that the speaker have a sufficiently great interest in the subject to justify communication.

Section 8 permits a corporation to communicate to the public its views on certain referendum subjects—those materially affecting its business—but not others. It also singles out one kind of ballot question—individual taxation as a subject about which corporations may never make their ideas public. The legislature has drawn the line between permissible and impermissible speech

according to whether there is a sufficient nexus, as defined by the legislature, between the issue presented to the voters and the business interests of the speaker.

In the realm of protected speech, the legislature is constitutionally disqualified from dictating the subjects about which persons may speak and the speakers who may address a public issue. If a legislature may direct business corporations to "stick to business," it also may limit other corporations—religious, charitable, or civic—to their respective "business" when addressing the public. Such power in government to channel the expression of views is unacceptable under the First Amendment. Especially where, as here, the legislature's suppression of speech suggests an attempt to give one side of a debatable public question an advantage in expressing its views to the people, the First Amendment is plainly offended.

Because that portion of § 8 challenged by appellants prohibits protected speech in a manner unjustified by a compelling state interest, it must be invalidated. The judgment of the Supreme Judicial Court is reversed.

? Case Questions

1. According to the court, does § 8 abridge a freedom that the First Amendment is intended to protect? If so, which freedom(s)?
2. Must a corporation prove a material effect on its business or property to maintain protection under the First Amendment?
3. Can a state legislature dictate the subjects on which a corporation may "speak"?

Piercing the Corporate Veil

United States v. Bestfoods

113 F.3d 572 (1998)

SOUTER, JUSTICE

The United States brought this action under §107(a)(2) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) against, among others, respondent CPC International, Inc., the parent corporation of the defunct Ott Chemical Co. (Ott II), for the costs of cleaning up industrial waste generated by Ott II's chemical plant. Section 107(a)(2) authorizes suits against, among others, "any person who at the time of disposal of any hazardous substance owned or operated any facility." The trial focused on whether CPC, as a parent corporation, had "owned or operated" Ott II's plant within the meaning of §107(a)(2). The District Court said that operator liability may attach to a parent corporation both indirectly, when the corporate veil can be pierced under state law, and directly, when the parent has exerted power or influence over its subsidiary by actively participating in, and exercising control over, the subsidiary's business during a period of hazardous waste disposal. Applying that test, the court held CPC liable because CPC had selected Ott II's board of directors and populated its executive ranks with CPC officials, and another CPC official had played a significant role in shaping Ott II's environmental compliance policy.

The Sixth Circuit reversed. Although recognizing that a parent company might be held directly liable under §107(a)(2) if it actually operated its subsidiary's facility in the stead of the subsidiary, or alongside of it as a joint venturer, that court refused to go further. Rejecting the District Court's analysis, the Sixth Circuit explained that a parent corporation's liability for operating a facility ostensibly operated by its subsidiary depends on whether the degree to which the parent controls the subsidiary and the extent and manner of its involvement with the facility amount to the abuse of the corporate form that will warrant piercing the corporate veil and disregarding the separate corporate entities of the parent and subsidiary. Applying Michigan veil-piercing law, the court decided that CPC was not liable for controlling Ott II's actions, since the two corporations maintained separate personalities and CPC did not utilize the subsidiary form to perpetrate fraud or subvert justice.

Held:

1. When (but only when) the corporate veil may be pierced, a parent corporation may be charged with derivative CERCLA liability for its subsidiary's actions in operating a polluting facility. It is a general principle of corporate law that a parent corporation (so-called because of control through ownership of another corporation's stock) is not liable for the acts of its subsidiaries. CERCLA does not purport to reject this bedrock principle, and the Government has indeed made no claim that a corporate parent is liable as an owner or an operator under §107(a)(2) simply because its subsidiary owns or operates a polluting facility. But there is an equally fundamental principle of corporate law, applicable to the parent-subsidiary relationship as well as generally, that the corporate veil

may be pierced and the shareholder held liable for the corporation's conduct when, *inter alia*, the corporate form would otherwise be misused to accomplish certain wrongful purposes, most notably fraud, on the shareholder's behalf. CERCLA does not purport to rewrite this well-settled rule, either, and against this venerable common-law backdrop, the congressional silence is audible. Cf. *Edmonds* v. *Compagnie Generale Transatlantique*, 443 U.S. 256, 266-267. CERCLA's failure to speak to a matter as fundamental as the liability implications of corporate ownership demands application of the rule that, to abrogate a common-law principle, a statute must speak directly to the question addressed by the common law. *United States* v. *Texas*, 507 U.S. 529, 534.

2. A corporate parent that actively participated in, and exercised control over, the operations of its subsidiary's facility may be held directly liable in its own right under §107(a)(2) as an operator of the facility.

(a) Derivative liability aside, CERCLA does not bar a parent corporation from direct liability for its own actions. Under the plain language of §107(a)(2), any person who operates a polluting facility is directly liable for the costs of cleaning up the pollution, and this is so even if that person is the parent corporation of the facility's owner. Because the statute does not define the term "operate," however, it is difficult to define actions sufficient to constitute direct parental "operation." In the organizational sense obviously intended by CERCLA, to "operate" a facility ordinarily means to direct the workings of, manage, or conduct the affairs of the facility. To sharpen the definition for purposes of CERCLA's concern with environmental contamination, an operator must manage, direct, or conduct operations specifically related to the leakage or disposal of hazardous waste, or decisions about compliance with environmental regulations.

(b) The Sixth Circuit correctly rejected the direct liability analysis of the District Court, which mistakenly focused on the relationship between parent and subsidiary, and premised liability on little more than CPC's ownership of Ott II and its majority control over Ott II's board of directors. Because direct liability for the parent's operation of the facility must be kept distinct from derivative liability for the subsidiary's operation of the facility, the analysis should instead have focused on the relationship between CPC and the facility itself, *i.e.*, on whether CPC "operated" the facility, as evidenced by its direct participation in the facility's activities. That error was compounded by the District Court's erroneous assumption that actions of the joint officers and directors were necessarily attributable to CPC, rather than Ott II, contrary to time-honored common-law principles. The District Court's focus on the relationship between parent and subsidiary (rather than parent and facility), combined with its automatic attribution of the actions of dual officers and directors to CPC, erroneously, even if unintentionally, treated CERCLA as though it displaced or fundamentally altered common-law standards of limited liability. The District Court's analysis created what is in essence a relaxed, CERCLA-specific rule of derivative liability that would banish traditional standards and expectations from the law of CERCLA liability. Such a rule does not arise from congressional silence, and CERCLA's silence is dispositive.

(c) Nonetheless, the Sixth Circuit erred in limiting direct liability under CERCLA to a parent's sole or joint venture operation, so as to eliminate any possible finding that CPC is liable as an operator on the facts of this case. The ordinary meaning of the word "operate" in the organizational sense is not limited to those two parental actions, but extends also to situations in which, *e.g.*, joint officers or directors conduct the affairs of the facility on behalf of the parent, or agents of the parent with no position in the subsidiary manage or direct activities at the subsidiary's facility. Norms of corporate behavior (undisturbed by any CERCLA provision) are crucial reference points, both for determining whether a dual officer or director has served the parent in conducting operations at the facility, and for distinguishing a parental officer's oversight of a subsidiary from his control over the operation of the subsidiary's facility. There is, in fact, some evidence that an agent of CPC alone engaged in activities at Ott II's plant that were eccentric under accepted norms of parental oversight of a subsidiary's facility: The District Court's opinion speaks of such an agent who played a conspicuous part in dealing with the toxic risks emanating from the plant's operation. The findings in this regard are enough to raise an issue of CPC's operation of the facility, though this Court draws no ultimate conclusion, leaving the issue for the lower courts to reevaluate and resolve in the first instance.

113 F.3d 572, vacated and remanded.

? Case Questions

1. In what ways can operator liability attach to a parent corporation? How did the Sixth Circuit Court disagree with the district court's analysis?
2. Is direct liability for a parent company's operation of the facility distinct from derivative liability for the subsidiary's operation of the facility? Should the focus be on parent and subsidiary or on parent and facility?

3. What norms of corporate behavior does the court look to in determining whether an officer or a director is involved in the operation of a facility?

Corporate Promoter

RKO-Stanley Warner Theatres, Inc. v. Graziano

355 A.2d. 830 (1976)

EAGEN, JUSTICE.

On April 30, 1970, RKO-Stanley Warner Theatres, Inc. [RKO], as seller, entered into an agreement of sale with Jack Jenofsky and Ralph Graziano, as purchasers. This agreement contemplated the sale of the Kent Theatre, a parcel of improved commercial real estate located at Cumberland and Kensington Avenues in Philadelphia, for a total purchase price of $70,000. Settlement was originally scheduled for September 30, 1970, and, at the request of Jenofsky and Graziano, continued twice, first to October 16, 1970, and then to October 21, 1970. However, Jenofsky and Graziano failed to complete settlement on the last scheduled date.

Subsequently, on November 13, 1970, RKO filed a complaint in equity seeking judicial enforcement of the agreement of sale. Although Jenofsky, in his answer to the complaint, denied personal liability for the performance of the agreement, the chancellor, after a hearing, entered a decree nisi granting the requested relief sought by RKO.…This appeal ensued.

At the time of the execution of this agreement, Jenofsky and Graziano were engaged in promoting the formation of a corporation to be known as Kent Enterprises, Inc. Reflecting these efforts, Paragraph 19 of the agreement, added by counsel for Jenofsky and Graziano, recited:

It is understood by the parties hereto that it is the intention of the Purchaser to incorporate. Upon condition that such incorporation be completed by closing, all agreements, covenants, and warranties contained herein shall be construed to have been made between Seller and the resultant corporation and all documents shall reflect same.

In fact, Jenofsky and Graziano did file Articles of Incorporation for Kent Enterprises, Inc., with the State Corporation Bureau on October 9, 1971, twelve days prior to the scheduled settlement date. Jenofsky now contends the inclusion of Paragraph 19 in the agreement and the subsequent filing of incorporation papers, released him from any personal liability resulting from the non-performance of the agreement.

The legal relationship of Jenofsky to Kent Enterprises, Inc., at the date of the execution of the agreement of sale was that of promoter. As such, he is subject to the general rule that a promoter, although he may assume to act on behalf of a projected corporation and not for himself, will be held personally liable on contracts made by him for the benefit of a corporation he intends to organize. This personal liability will continue even after the contemplated corporation is formed and has received the benefits of the contract, unless there is a novation or other agreement to release liability.

The imposition of personal liability upon a promoter where that promoter has contracted on behalf of a corporation is based upon the principle that one who assumes to act for a nonexistent principal is himself liable on the contract in the absence of an agreement to the contrary.

[T]here [are] three possible understandings that parties may have when an agreement is executed by a promoter on behalf of a proposed corporation:

When a party is acting for a proposed corporation, he cannot, of course, bind it by anything he does, at the time, but he may (1) take on its behalf an offer from the other which, being accepted after the formation of the company, becomes a contract; (2) make a contract at the time binding himself, with the stipulation or understanding, that if a company is formed it will take his place and that then he shall be relieved of responsibility; or (3) bind himself personally without more and look to the proposed company, when formed, for indemnity.

Both RKO and Jenofsky concede the applicability of alternative No. 2 to the instant case. That is, they both recognize that Jenofsky (and Graziano) was to be initially personally responsible with this personal responsibility subsequently being released. Jenofsky contends the parties, by their inclusion of Paragraph 19 in the agreement, manifested an intention to release him from personal responsibility upon the mere formation of the proposed corporation, provided the incorporation was consummated prior to the scheduled closing date. However, while Paragraph 19 does make provision for recognition of the resultant corporation as to the

closing documents, it makes no mention of any release of personal liability. Indeed, the entire agreement is silent as to the effect the formation of the projected corporation would have upon the personal liability of Jenofsky and Graziano. Because the agreement fails to provide expressly for the release of personal liability, it is, therefore, subject to more than one possible construction.

In *Consolidated Tile and Slate Co. v. Fox*, 410 Pa. 336,339,189 A.2d 228, 229 (1963), we stated that where an agreement is ambiguous and reasonably susceptible of two interpretations, "it must be construed most strongly against those who drew it."… Instantly, the chancellor determined that the intent of the parties to the agreement was to hold Jenofsky personally responsible until such time as a corporate entity was formed and until such time as that corporate entity adopted the agreement. We believe this construction represents the only rational and prudent interpretation of the parties' intent.

As found by the court below, this agreement was entered into on the financial strength of Jenofsky and Graziano, alone as individuals. Therefore, it would have been illogical for RKO to have consented to the release of their personal liability upon the mere formation of a resultant corporation prior to closing. For it is a well-settled rule that a contract made by a promoter, even though made for and in the name of a proposed corporation, in the absence of a subsequent adoption (either expressly or impliedly) by the corporation, will not be binding upon the corporation. If, as Jenofsky contends, the intent was to release personal responsibility upon the mere incorporation prior to closing, the effect of the agreement would have been to create the possibility that RKO, in the event of non-performance, would be able to hold no party accountable: there being no guarantee that the resultant corporation would ratify the agreement. Without express language in the agreement indicating that such was the intention of the parties, we may not attribute this intention to them.

Therefore, we hold that the intent of the parties in entering into this agreement was to have Jenofsky and Graziano personally liable until such time as the intended corporation was formed and ratified the agreement. [And there is no evidence that Kent Enterprises ratified the agreement. The decree is affirmed.]

? Case Questions

1. Does a promoter's personal liability continue even after the corporation is formed? Can he or she look to the corporation for indemnity after the corporation is formed?
2. In what instance(s) is a contract made by a promoter not binding on a corporation?
3. In whose favor does a court construe an ambiguous agreement?

De Jure and De Facto Corporations

Cranson v. International Business Machines Corp.

234 Md. 477, 200 A.2d 33 (1964)

HORNEY, JUDGE

On the theory that the Real Estate Service Bureau was neither a *de jure* nor a *de facto* corporation and that Albion C. Cranson, Jr., was a partner in the business conducted by the Bureau and as such was personally liable for its debts, the International Business Machines Corporation brought this action against Cranson for the balance due on electric typewriters purchased by the Bureau. At the same time it moved for summary judgment and supported the motion by affidavit. In due course, Cranson filed a general issue plea and an affidavit in opposition to summary judgment in which he asserted in effect that the Bureau was a *de facto* corporation and that he was not personally liable for its debts.

The agreed statement of facts shows that in April 1961, Cranson was asked to invest in a new business corporation which was about to be created. Towards this purpose he met with other interested individuals and an attorney and agreed to purchase stock and become an officer and director. Thereafter, upon being advised by the attorney that the corporation had been formed under the laws of Maryland, he paid for and received a stock certificate evidencing ownership of shares in the corporation, and was shown the corporate seal and minute book. The business of the new venture was conducted as if it were a corporation, through corporate bank accounts, with auditors maintaining corporate books and records, and under a lease entered into by the corporation for the office from which it operated its business. Cranson was elected president and all transactions conducted by him for the corporation, including the dealings with I.B.M., were made as an officer of the corporation. At no time did he assume any personal obligation or pledge his individual credit to I.B.M. Due to an oversight on the part of the attorney, of which Cranson was not aware, the

certificate of incorporation, which had been signed and acknowledged prior to May 1, 1961, was not filed until November 24, 1961. Between May 17 and November 8, the Bureau purchased eight typewriters from I.B.M., on account of which partial payments were made, leaving a balance due of $4,333.40, for which this suit was brought.

Although a question is raised as to the propriety of making use of a motion for summary judgment as the means of determining the issues presented by the pleadings, we think the motion was appropriate. Since there was no genuine dispute as to the material facts, the only question was whether I.B.M. was entitled to judgment as a matter of law. The trial court found that it was, but we disagree.

The fundamental question presented by the appeal is whether an officer of a defectively incorporated association may be subjected to personal liability under the circumstances of this case. We think not.

Traditionally, two doctrines have been used by the courts to clothe an officer of a defectively incorporated association with the corporate attribute of limited liability. The first, often referred to as the doctrine of *de facto* corporations, has been applied in those cases where there are elements showing: (1) the existence of law authorizing incorporation; (2) an effort in good faith to incorporate under the existing law; and (3) actual use or exercise of corporate powers. The second, the doctrine of estoppel to deny the corporate existence, is generally employed where the person seeking to hold the officer personally liable has contracted or otherwise dealt with the association in such a manner as to recognize and in effect admit its existence as a corporate body.

* * *

There is, as we see it, a wide difference between creating a corporation by means of the *de facto* doctrine and estopping a party, due to his conduct in a particular case, from setting up the claim of no incorporation. Although some cases tend to assimilate the doctrines of incorporation *de facto* and by estoppel, each is a distinct theory and they are not dependent on one another in their application. Where there is a concurrence of the three elements necessary for the application of the *de facto* corporation doctrine, there exists an entity which is a corporation *de jure* against all persons but the state.

On the other hand, the estoppel theory is applied only to the facts of each particular case and may be invoked even where there is no corporation *de facto*. Accordingly, even though one or more of the requisites of a *de facto* corporation are absent, we think that this factor does not preclude the application of the estoppel doctrine in a proper case, such as the one at bar.

I.B.M. contends that the failure of the Bureau to file its certificate of incorporation debarred *all* corporate existence. But, in spite of the fact that the omission might have prevented the Bureau from being either a corporation *de jure* or *de facto*, Jones v. Linden Building Ass'n, we think that I.B.M. having dealt with the Bureau as if it were a corporation and relied on its credit rather than that of Cranson, is estopped to assert that the Bureau was not incorporated at the time the typewriters were purchased. In 1 Clark and Marshall, Private Corporations, § 89, it is stated:

The doctrine in relation to estoppel is based upon the ground that it would generally be inequitable to permit the corporate existence of an association to be denied by persons who have represented it to be a corporation, or held it out as a corporation, or by any persons who have recognized it as a corporation by dealing with it as such; and by the overwhelming weight of authority, therefore, a person may be estopped to deny the legal incorporation of an association which is not even a corporation *de facto*.

In cases similar to the one at bar, involving a failure to file articles of incorporation, the courts of other jurisdictions have held that where one has recognized the corporate existence of an association, he is estopped to assert the contrary with respect to a claim arising out of such dealings.

Since I.B.M. is estopped to deny the corporate existence of the Bureau, we hold that Cranson was not liable for the balance due on account of the typewriters.

Judgment reversed; the appellee to pay the costs.

? Case Questions

1. What is the fundamental question presented by the case?
2. What are the differences between creating a corporation de facto and by estoppel?

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14.8: Summary and Exercises

Summary

The hallmark of the corporate form of business enterprise is limited liability for its owners. Other features of corporations are separation of ownership and management, perpetual existence, and easy transferability of interests. In the early years of the common law, corporations were thought to be creatures of sovereign power and could be created only by state grant. But by the late nineteenth century, corporations could be formed by complying with the requirements of general corporation statutes in virtually every state. Today the standard is the Revised Model Business Corporation Act.

The corporation, as a legal entity, has many of the usual rights accorded natural persons. The principle of limited liability is broad but not absolute: when the corporation is used to commit a fraud or an injustice or when the corporation does not act as if it were one, the courts will pierce the corporate veil and pin liability on stockholders.

Besides the usual business corporation, there are other forms, including not-for-profit corporations and professional corporations. Business corporations are classified into two types: publicly held and closely held corporations.

To form a corporation, the would-be stockholders must choose the state in which they wish to incorporate. The goal of the incorporation process is issuance of a corporate charter. The charter is a contract between the state and the corporation. Although the Constitution prohibits states from impairing the obligation of contracts, states reserve the right to modify corporate charters.

The corporation is created by the incorporators (or promoters), who raise capital, enter into contracts on behalf of the corporation to be formed, and prepare the articles of incorporation. The promoters are personally liable on the contracts they enter into before the corporation is formed. Incorporators owe a fiduciary duty to each other, to investors, and to the corporation.

The articles of incorporation typically contain a number of features, including the corporate name, corporate purposes, total number of shares and classes into which they are divided, par value, and the like. The name must include one of the following words (or abbreviations): corporation, company, incorporated, or limited (Corp., Co., Inc., or Ltd.). The articles of incorporation must be filed with the secretary of state. Once they have been filed, the board of directors named in the articles must adopt bylaws, elect officers, and conduct other necessary business. The directors are empowered to alter the bylaws, subject to repeal or change by the shareholders.

Even if the formal prerequisites to incorporation are lacking, a de facto corporation will be held to have been formed if (1) a statute exists under which the corporation could have been validly incorporated, (2) the promoters made a bona fide attempt to comply with the statute, and (3) a corporate privilege was exercised. Under appropriate circumstances, a corporation will be held to exist by estoppel.

Exercises

1. Two young business school graduates, Laverne and Shirley, form a consulting firm. In deciding between the partnership and corporation form of organization, they are especially concerned about personal liability for giving bad advice to their clients; that is, in the event they are sued, they want to prevent plaintiffs from taking their personal assets to satisfy judgments against the firm. Which form of organization would you recommend? Why?
2. Assume that Laverne and Shirley in Exercise 1 must negotiate a large loan from a local bank in order to finance their firm. A friend advises them that they should incorporate in order to avoid personal liability for the loan. Is this good advice? Why?
3. Assume that Laverne and Shirley decide to form a corporation. Before the incorporation process is complete, Laverne enters into a contract on behalf of the corporation to purchase office furniture and equipment for $20,000. After the incorporation process has been completed, the corporation formally accepts the contract made by Laverne. Is Laverne personally liable on the contract before corporate acceptance? After corporate acceptance? Why?
4. Assume that Laverne and Shirley have incorporated their business. One afternoon, an old college friend visits Shirley at the office. Shirley and her friend decide to go out for dinner to discuss old times. Shirley, being short of cash, takes money from a petty cash box to pay for dinner. (She first obtains permission from Laverne, who has done the same thing many times in the past.) Over dinner, Shirley learns that her friend is now an IRS agent and is investigating Shirley's corporation. What problems does Shirley face in the investigation? Why?

5. Assume that Laverne and Shirley prepare articles of incorporation but forget to send the articles to the appropriate state office. A few months after they begin to operate their consulting business as a corporation, Laverne visits a client. After her meeting, in driving out of a parking lot, Laverne inadvertently backs her car over the client, causing serious bodily harm. Is Shirley liable for the accident? Why?
6. Ralph, a resident of Oklahoma, was injured when using a consumer product manufactured by a corporation whose principal offices were in Tulsa. Since his damages exceeded $10,000, he filed a products-liability action against the company, which was incorporated in Delaware, in federal court. Does the federal court have jurisdiction? Why?
7. Alice is the president and only shareholder of a corporation. The IRS is investigating Alice and demands that she produce her corporate records. Alice refuses, pleading the Fifth Amendment privilege against self-incrimination. May the IRS force Alice to turn over her corporate records? Why?

SELF CHECK QUESTIONS

1. In comparing partnerships with corporations, the major factor favoring the corporate form is
    1. ease of formation
    2. flexible financing
    3. limited liability
    4. control of the business by investors
2. A corporation with no part of its income distributable to its members, directors, or officers is called
    1. a publicly held corporation
    2. a closely held corporation
    3. a professional corporation
    4. a nonprofit corporation
3. A corporation in which stock is widely held or available through a national or regional stock exchange is called
    1. a publicly held corporation
    2. a closely held corporation
    3. a public corporation
    4. none of the above
4. Essential to the formation of a de facto corporation is
    1. a statute under which the corporation could have been validly incorporated
    2. promoters who make a bona fide attempt to comply with the corporation statute
    3. the use or exercise of corporate powers
    4. each of the above
5. Even when incorporators miss important steps, it is possible to create
    1. a corporation by estoppel
    2. a de jure corporation
    3. an S corporation
    4. none of the above

AnswerS

1. c
2. d
3. a
4. d
5. a

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CHAPTER OVERVIEW

15: Property

Learning Objectives

- Distinguish between personal property and real property.
- Understand classifications of property.
- Examine methods of acquisition of real and personal property.
- Examine the landlord-tenant relationship.
- Understand how property is transferred through wills and trusts.
- Explore common land use regulations and environmental laws that businesses face.

15.1: Introduction
15.2: Personal Property
15.3: Real Property
15.4: Wills and Trusts
15.5: Concluding Thoughts

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15.1: Introduction

Property refers to tangible and intangible items that can be owned. **Ownership** is a concept that means the right to exclude others. Legal systems create a peaceful means to acquire, retain, and divest property, and to settle property disputes. Businesses need to understand the legal system regarding both personal and real property because they often own or lease both. In addition, the government regulates how real property can be used as well as any environmental impact a business has.

Counselor's Corner

Property is regulated by state laws. Because of the variation of laws from state to state, it is imperative that businesses understand all legal requirements where they have property interests. Property can be a great seducer–it seems like owning or possessing property is an asset. However, the liability that comes with it may not be in the business's best interest. Take the time to assess the financial and legal risks and rewards before acquiring property interests to ensure that you are not overextending yourself. ~Elizabeth H., judge

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15.2: Personal Property

Property can be classified as real or personal. **Real property** is land, and certain things that are attached to it or associated with it. Real property is raw land, such as a forest or a field, as well as buildings, like a house or an office. Additionally, things associated with land, like mineral rights, are also real property. People often talk about real property by using the term **real estate**, which includes both real property and its related ownership interest.

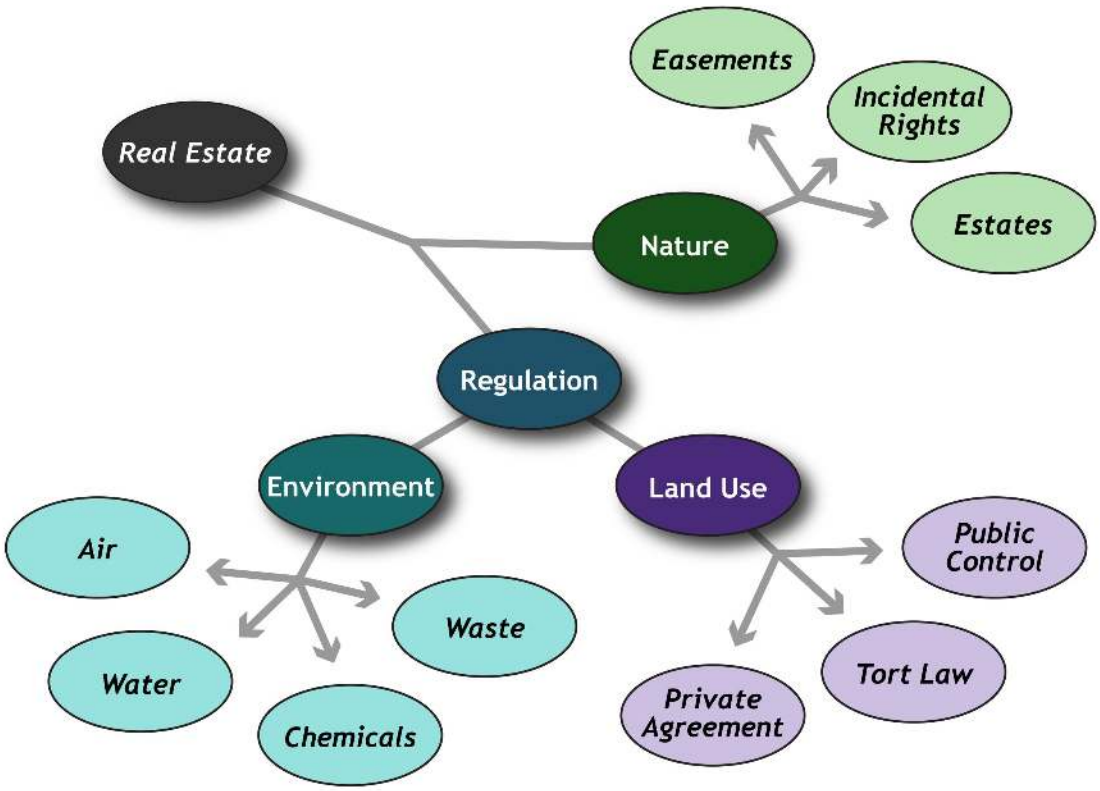


Figure 22.1 Types of Real Estate Legal Issues

Personal property is property that is not real property. **Tangible property** is something that can be touched. Moveable, tangible personal property is called **chattel**. Many businesses exist to sell personal property. For example, the primary purpose of retailers is to sell personal property. Some property can also be described as fungible property. Property that can easily be substituted with identical property is said to be **fungible**. Types of fungible goods include juices, oil, metals such as steel or aluminum, and physical monetary currency.

Intangible property does not physically exist, but it is still subject to ownership principles, including acquisition, transfer, and sale. For instance, the right to payment under a contract, the right to exclude others from a patented product, and the right to prohibit others from using copyrighted materials are all examples of intangible property.

Personal property can become attached to the land as a fixture. A **fixture** is something that used to be personal property, but it has become attached to the land so that it is legally a part of the land. Fixtures are treated like real property so when real property is transferred, fixtures are transferred as a part of the real property. A ceiling fan for sale at a store is personal property. However, once the fan is installed in a house, it becomes a fixture and is part of the real property.

Some things that are attached to the land are not fixtures but are part of the real property itself. Imagine a farm with planted corn. The corn crop is an example of real property that can become personal property. While the corn is growing and still attached to the

land, the corn is real property. Once it is picked from the stalk, the ear of corn becomes personal property.

Property also can be classified by ownership. Personal and real property can be private or public. **Private property** is owned by someone or some entity that is not the government, such as individuals, corporations, and partnerships. Private property can include real property like land or buildings, and personal property, such as vehicles, furniture, and computers. Property that is owned by the government is **public property**. Rocky Mountain National Park is an example of public property that is real property. Public property can also include personal property, such as vehicles and computers owned by state or local governments.

Methods of Acquisition of Personal Property

Personal property may be acquired in several different ways. For example, **ownership by production** occurs when one produces something. However, if an employee produces a good as part of his or her job, then the employer will own the property, not the employee. **Ownership by purchase** is the most common method of acquiring property. For example, if a customer buys a good, then the customer owns it through purchase from the manufacturer.

Property may also be gifted. A **gift** is a voluntary transfer of property. Generally, the donor of the gift must intend to gift the property, the donor must deliver the gift, and the gift must be accepted by the intended recipient. A **conditional gift** is a gift that requires a condition to be met before the gift will transfer, such as a wedding or graduation.

Property that someone finds can be classified in several ways. If property is **abandoned**, a person who finds it may claim ownership. However, the original owners of abandoned property must intend to relinquish ownership in it. For example, if someone takes a chair to the landfill, he or she has abandoned the chair. Someone may come along and take legal possession of it. However, if the property is simply **lost or mislaid**, then the finder must relinquish it once the rightful owner demands its return. Another classification of personal property applicable to found property is treasure trove. A **treasure trove** is money or precious metals, like gold, which is hidden in the ground or other private place by an unknown owner. Whoever finds a treasure trove becomes the owner unless the true owner (i.e. the person who hid it) comes forward.

Type of Property	Description	Rights of Finder	Rights of Owner
Abandoned	Owner intentionally parted with property with intent to relinquish ownership rights	Finder acquires rights to the property	None
Lost	Owner unintentionally parted with possession of the property	Finder has rights to the property against everyone except the owner	Owner has right to have property returned because owner never lost ownership interest
Mislaid	Owner intentionally placed property in a specific place but has forgotten where	Finder has no rights and cannot keep property	Owner has right to have property returned because owner never lost ownership interest
Treasure Trove	Owner intentionally hid property	Finder acquires rights to the property unless the owner comes forward	Owner must come forward to maintain right to property; if not, finder becomes new owner

Bailment

Sometimes it is necessary to intentionally leave personal property with someone else. A **bailor** is someone in the rightful possession of personal property who gives the property to someone else to hold, who is called a **bailee**. A **bailment** is the arrangement in which the personal property is exchanged. The bailee agrees to accept the property and has the duty to return it. For example, a customer gives clothes to a dry cleaner. The dry cleaner is a bailee and has a duty to return the clothes (personal property) upon demand by the customer, who is the bailor.

Bailments may be voluntary or involuntary. A **voluntary bailment** is created when intention exists to create the bailment, as described in the dry cleaner example above. An **involuntary bailment** is created when someone finds lost or mislaid property. The

finder may not destroy the property, though the duties that he or she owes regarding the property may vary from state to state.

Bailment is common in business, including placing packages with common carriers for delivery, warehousing goods with a third party, or taking clients' or customers' automobiles in a valet service.

The duty of care that the bailee owes to a bailor depends on the nature and value of the property involved, as well as who benefits from the bailment. In general, a higher standard of care is required for more valuable property. Damages in a bailment case are based on the retail replacement value of the property.

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15.3: Real Property

Real property is land, and certain things that are attached to or associated with it. Real property includes undeveloped land, like a field, and it includes buildings, such as houses, and office buildings. Real property also includes things associated with the land, like subsurface rights (rights to minerals and things found beneath the surface).

Methods of Acquisition

Real property may be acquired by purchase, inheritance, gift, or through adverse possession. Ownership rights are transferred by **title**. Ownership of real property means that the owner has the right to possess the property, as well as the right to exclude others, within the boundaries of the law. If someone substantially interferes with the use and enjoyment of real property, the owner may bring a nuisance claim. Similarly, the owner may bring a trespass claim against those who enter the land without consent or permission.

Purchase

Land owners may convey or sell part or all of their land interests. Different types of deeds convey different types of interests. A **quitclaim deed**, for instance, conveys whatever interests in title that the grantor has in the property to the party to whom the quitclaim is given. That means if the grantor has no interests in the real property, a conveyance by quitclaim will not grant any interests in the property. By comparison, a **warranty deed** conveys title and the seller gives a warranty against defects in title as well as encumbrances. Buyers typically demand a warranty deed when they purchase property because the seller assumes the risk of the title not being clear.

After title is transferred by the deed, the deed is recorded in the county where the property is located. Recording a deed is important because it places others on notice about who owns the property. States have different rules about who is considered the legitimate owner when a conflict in ownership claim exists. A **bona fide purchaser** is a purchaser who takes title in good faith, with no knowledge of competing claims to title. Many states recognize a bona fide purchaser's rights to ownership over those who did not properly record a deed.

Inheritance

Another common way in which real property may be obtained is through inheritance. Real property may be bequeathed through a will or may be transferred by state law when someone dies without a will. Generally speaking, people have the right to dispose of their property as they wish when they die, providing that their will or other transfer instrument meets their state's requirements for validity. If someone dies without living relatives, the government becomes the owner of the property.

Gift

Real property may also be acquired through a gift. A gift is valid when:

1. The person giving property intends to make the gift;
2. The person delivers the deed to the recipient; and
3. The recipient accepts the gift.

If one of these elements is not met, then title will not be conveyed.

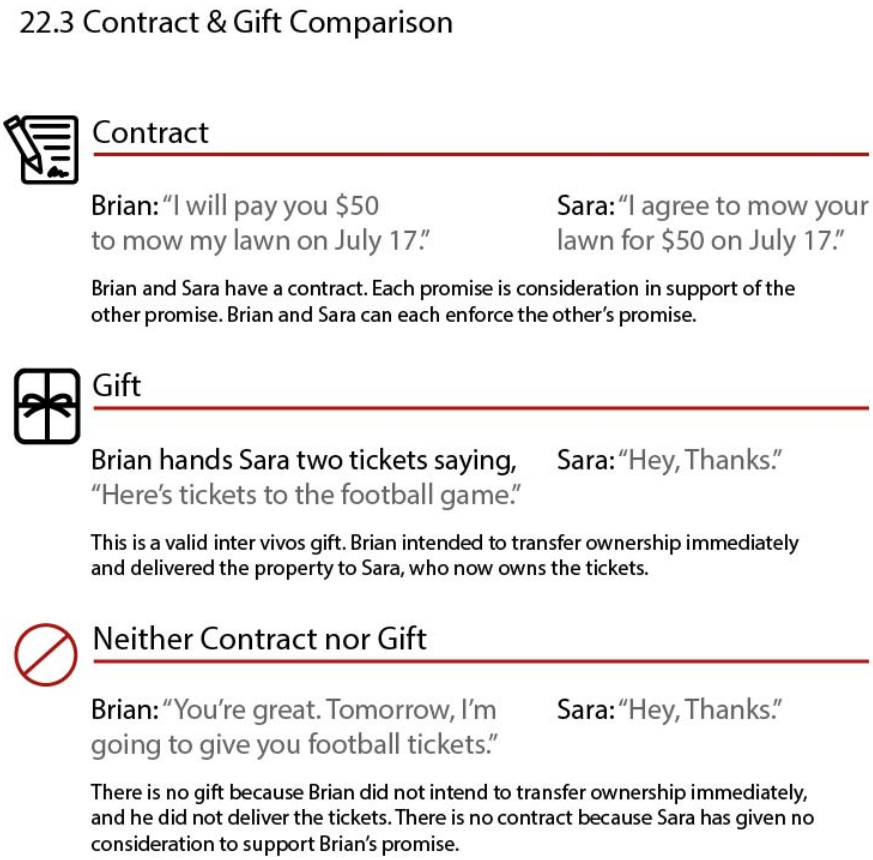


Figure 22.2 Comparison of Contract and Gift

Adverse Possession

A less common way to acquire real property is through the doctrine of adverse possession. **Adverse possession** is when someone who is not the owner of real property has claimed the real property for his own. This is referred to as "squatter's rights." If land sits idle at the owner's hands but someone else puts it to use, then the law may favor the user's claim to the land over that of the actual owner. Adverse possession claims often occur around property lines, where one party has routinely used another's property because a fence has been misplaced.

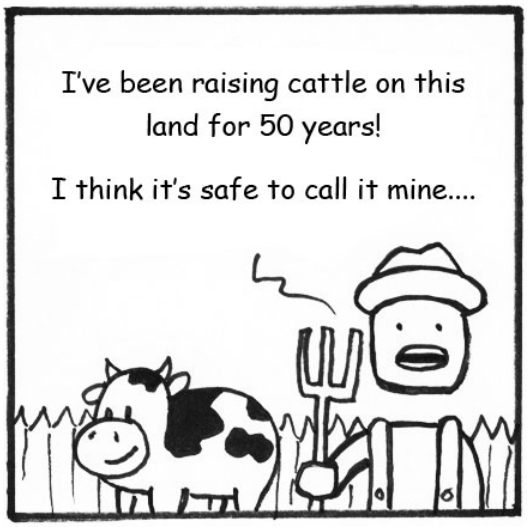


Figure 22.3 Adverse Possession Cartoon

Interests and Scope

Owning real property carries many responsibilities, as well as the potential for great profit and great liability. It is important to learn how to protect against potential liability of property ownership. For instance, if a toxic waste site is discovered on real property, the owner may be liable for its cleanup, even if he or she did not realize that such a site was there when purchasing the land. Each buyer of real property has a duty to exercise due diligence when purchasing land. A purchaser should never agree to buy land "sight unseen" or without a professional inspector.

It is important to know the duties of landowners, how to limit liability associated with the ownership of land, and when severance of liability occurs.

Duties of Landowners

Landowners owe different duties to different types of people who enter their land. These responsibilities vary, depending on whether the person is a trespasser, a licensee, or an invitee.

A **trespasser** is a person who intentionally enters the land of another without permission. A landowner has a duty to not intentionally injure a trespasser. For instance, booby traps and pitfalls are illegal. Trespassers injured from such traps have valid claims against the landowner. However, if trespassers are injured from unknown or unforeseeable dangers, the owner is not usually liable.

A **licensee** is someone who has permission to be on the land. Landowners have a higher duty of care to such a person. Licensees include delivery people, meter readers, and utility workers. A landowner must not intentionally injure a licensee and must warn the licensee of known defects. For example, if a landowner knows that the steps to his or her porch are icy, he or she has a duty to warn a licensee that those steps are icy. Failure to do so may result in liability for the landowner.

An **invitee** is someone who has entered real property by invitation. Businesses and public places that want members of the community to visit have issued invitations to the public. Landowners must inspect their property for defects, correct those defects when found, and warn invitees about such defects. For example, a grocery store must clean up spills as quickly as possible and put up a "caution" sign in that area.

Ownership Interests in Real Property

Different types of interests may be owned in real property. For example, real property may be owned without restriction, subject only to local, state, and federal laws. Sometimes ownership interests may be narrower, subject to conditions, the violation of which can lead to loss of those ownership interests.

The most complete ownership interest recognized by law is called **fee simple absolute**. This ownership allows the owner complete control over the land and lasts until the owner dies or conveys the property to someone else. Generally, if someone wants to buy real property, he or she is looking to buy property in fee simple absolute.

Compare that with a defeasible fee. A **fee simple defeasible** is subject to a condition of ownership or to some future event. For instance, if an owner donates land to a city "so long as it is used as a public greenway," then the land would be owned in defeasible fee by the city as long as it maintains it as a public greenway. Once the condition is violated, the land would revert back to either the original owner or whoever owned the **reversion interest**, which is a future interest in real property.

Another ownership interest is a **life estate**. This interest is measured by the life of the owner. For example, a person could grant ownership rights in real property to a parent for the length of his or her life, but then the property would be returned upon the parent's death. A common investment, known as a reverse mortgage, employs the concept of life estate. A **reverse mortgage** is an arrangement where the purchaser of real property agrees to allow the seller of the property to retain possession of the property for a specified period of time (such as the remainder of his or her life) in exchange for the ability to purchase the property at today's price. These arrangements essentially gamble on life expectancies of the sellers of real property by granting life estates to them in the property.

Property can be owned by more than one owner. Several types of co-ownership interests are recognized in law. These ownership interests are important for matters of possession, right to transfer, right to profits from the land, and liability. For example, **tenancy in common** describes an ownership interest in which all owners have an equal right to possess the whole property. Compare this to

joint tenancy, in which the surviving owner has the right of survivorship. If one of the owners dies, his or her property interests automatically transfers to the remaining owner(s).

These different interests are created by specific wording in the instrument of conveyance. An owner in tenancy in common may sell or transfer his or her rights without seeking permission from the other owners. This is because owners in a tenancy in common have the unilateral right to transfer their interests in property. Conversely, to transfer one's interests in a joint tenancy, the consent and approval of the other owners is required.

Scope of Interests in Real Property

Scope of ownership determines what can (or cannot) be done with the land. The surface of the land and the buildings that are attached to the land are what most people think of about ownership of real property. However, land interests also include subsurface or mineral rights, and right to light or to a view. Moreover, water rights are granted differently, depending on whether the property is in the western or the eastern United States. Additionally, **easements** (the right to cross or otherwise use someone's land for a specified purpose) and **covenants** (guides or restraints on how one may build on their land) grant certain rights to non-possessors of land.

Subsurface Rights

Subsurface or mineral rights are rights to the substances beneath the actual surface of the land. Purchasing mineral rights allows the owner to extract and sell whatever exists under the surface of the land, such as oil, natural gas, and gold.

Water Rights

Water rights are determined in two different ways in the United States. Generally speaking, states east of the Mississippi River follow a riparian water rights doctrine, which means that those who live next to the water have a right to use the water. The water is shared among the riparian owners. However, most western states use the prior appropriation doctrine, which grants rights to those who used those rights "first in time." Under this concept, the use must be beneficial, but the owner of the right need not be an adjacent landowner. This policy has resulted in claims by "downstream" users having priority over landowners where water runs through the land. For example, casinos in Las Vegas, Nevada may have priority of water rights over ranchers in Colorado where a tributary runs through the ranch. Prior appropriation is a "use it or lose it" doctrine.

Easements and Covenants

Easements and covenants are nonpossessory interests in real property. An **easement** can be express or implied and it gives people the right to use another's land for a particular purpose. For example, a common easement is for utility companies to enter private property to maintain poles and power lines. Other examples include sidewalks and a landlocked property having an easement across another piece of property for the purpose of a driveway or walkway.

A **covenant** is a voluntary restriction on the use of land. Common covenants are homeowners associations' rules, which restrict the rights of the owners to use their land in certain ways, often for aesthetic purposes. For instance, such covenants might require houses subject to the covenant to be painted only in certain approved colors, or they might contain prohibitions against building swimming pools.

Some covenants and easements "run with the land," which means that the restrictions will apply to subsequent owners of the property. Whether a covenant or easement runs with the land depends on the type of interest granted.

Landlord-Tenant Relationships

A **leasehold interest** also may be created in real property. A tenant has the right to exclusive possession of the real property and the duty to follow the rules of occupancy set out by the landlord. The landlord has the right to be paid rent and the duty to ensure that the premises are habitable. If one party does not perform under the lease as required, the other party may seek a legal remedy for breach of contract. Most state laws also impose duties on landlords to maintain safe and habitable conditions on the property. Tenants also have a duty to use the premises properly and not to damage the property beyond normal wear and tear.

Different types of tenancies may be created:

Type of Tenancy	Description
Tenancy for years	• Lease lasts for a specified period of time; • Called tenancy for years regardless of how long the tenancy is for; • Once the time expires, so does the tenancy
Periodic tenancy	• Lease states when rent is due but does not have a set duration; • E.g. a month-to-month lease
Tenancy at will	• Lease may be terminated at any time by landlord or tenant; • Tenancy often created through actions of parties rather than written lease
Tenancy at Sufferance	• Tenant remains on the property after the right of possession has ended and without the landlord's consent; • Law views tenant as trespasser who is responsible for paying rent during holdover period; • Most states require landlord to evict tenant through formal eviction or unlawful detainer proceedings

Tenancies may be created for residential or commercial purposes. Commercial leases typically last for longer periods of time than residential leases. Many of the same responsibilities and duties exist with commercial leases, but there are some important differences. For example, a commercial tenant may demand that the landlord refuse to rent to a competitor of the tenant within the same building.

Lease interests are assignable unless those rights are expressly restricted by agreement. This means that the rights conveyed by the lease may be transferred to another party by assignment, unless expressly prohibited by the lease. Common restrictions on assignment in residential leases is a no-subletting clause. Just as the owner of real property may sell any or all of his or her interests, any ownership interest in real property may also be leased. For example, someone who owns the subsurface rights of land may lease the right to drill for oil or gas to another.

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15.4: Wills and Trusts

Both real and personal property may be transferred to another owner through wills and trusts. Although most people think of wills and trusts as a tool for conveying property owned by individuals, businesses property often needs to be transferred when the business owner dies. This is especially true for sole proprietorships and partnerships.

A **will** is a document by which an individual directs his or her estate to be distributed upon death. Wills must be in writing and signed by the individual(s) making them. Although state laws regarding wills vary slightly, most states require:

Requirement	Description
Legal age	• The individual must be 18 (16 in Louisiana, 14 in Georgia, under 18 in the military)
Testamentary intent	• Must make clear that document is a will through words such as “last will and testament”
Testamentary capacity	• The individual must be “of sound mind” and understand that he or she is creating a will, what property is being transferred & to whom it is being given
Signature	• The individual must sign the document
Witnesses	• There must be 2 adult witnesses to the individual signing the will; • Most states do not require the will to be notarized but this step is recognized as a best legal practice

A **trust** is a property interest held by one person or entity at the request of another for the benefit of a third party. For a trust to be valid, it must involve specific property, reflect the person’s or entity’s intent, and be created for a lawful purpose. Trusts are very popular for leaving property to benefit children who are under 18 years old, elderly, and people with disabilities.

When planning how to distribute property upon death, it is important to understand the difference between probate and non-probate assets. **Probate** is the process through which a court determines how to distribute property after someone dies. Some assets are distributed to heirs by the court (**probate assets**) and some assets bypass the court process and go directly to beneficiaries (**non-probate assets**). Probate assets generally are subject to inheritance taxes and distribution can be delayed until the court orders the distribution of the assets. Because of these drawbacks, many individuals prefer non-probate assets.

Probate Assets	Non-Probate Assets
• Real property titled solely in the decedent’s name or held in tenancy in common • Personal property, such as jewelry, furniture & vehicles • Bank accounts solely in the decedent’s name • Interest in a partnership, corporation or limited liability company • Life insurance policies or brokerage accounts identifying the decedent or his or her estate as a beneficiary	• Real property held in joint tenancy or tenancy by the entirety • Bank or brokerage accounts held in joint tenancy or with payable on death (POD) or transfer on death (TOD) beneficiaries • Real property, personal property, and money held in a trust • Life insurance or brokerage accounts identifying someone other than the decedent as a beneficiary • Retirement accounts

Death of a property owner impacts the ability to transfer property. The ownership interest dictates how the property may be transferred.

Type of Ownership	Death of Owner	Transfer	Where Available
Tenancy in Common	Owner's interest passes to heirs	Owner may transfer interest without agreement of co-owners	All states
Joint Tenancy	Owner's interest passes to the remaining joint tenants as non-probate asset	Owner may not transfer interest without agreement of co-owners	All states
Tenancy by Entirety	Owner's interest passes to the surviving spouse	Owner may not transfer interest without agreement of spouse	Approximately half of the states
Community Property	Half of owner's interest passes to the surviving spouse & other half passes to other heirs	Owner may not transfer interest without agreement of spouse	Only 9 states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas & Washington

If someone dies without a will or trust, the probate court will determine:

1. The nature and value of the decedent's estate;
2. The nature and value of any outstanding debts and tax obligations;
3. Whether the decedent has any heirs;
4. The identity of the heirs and their relationship to the decedent; and
5. What, if anything, the heirs are entitled to receive from the decedent's estate.

The essential role of the probate court is to ensure that the deceased person's creditors are paid and that any remaining assets are distributed to the proper beneficiaries. However, this process takes time and costs money from the deceased person's estate. And there is no guarantee that the deceased person intended his or her property to be distributed based on the state's rules on who qualifies as an heir and what they are entitled to receive. Business assets owned by the deceased person may complicate the probate process even more.

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15.5: Concluding Thoughts

Property is classified as real property or personal property, tangible or intangible, and private or public. Personal property can be transformed into real property when it is affixed to the land. Real property can be transformed into personal property when it is severed from the land. Personal property can be acquired for ownership through production, purchase, or gift or, in certain circumstances, by finding it. Bailments are legal arrangements in which the rightful possessor of personal property leaves the property with someone else who agrees to hold it and return it on demand.

When thinking about acquiring property, it is important to understand the rights and duties associated with acquiring it, the protections afforded to the owner, and how to transfer it to another party at the time of sale, lease, or licensing the right to use it. Real property includes land and the buildings attached to it, as well as the minerals below it. Personal property is everything else. Because property ownership includes exposure to liability, businesses need to take steps to protect people on their real property from hazards. Businesses are also subject to land use regulations and environmental laws for the use of their real property.

Real and personal property may be transferred to another owner through wills and trusts upon the death of the original owner. Businesses property often needs to be transferred when the business owner dies, and not having a will or trust in place to convey the property can complicate the probate process. Non-probate assets are popular to avoid inheritance taxes and delays in distributing assets.

Environmental laws have a big impact on businesses, especially manufacturers. The Clean Air Act and the Clean Water Act are federal laws that are implemented through the states, so businesses must work with both state and federal governments to ensure they are legally compliant. Businesses that want to open or expand their operations are required to prepare an environmental impact statement if they need federal approval.

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CHAPTER OVERVIEW

16: The Nature and Regulation of Real Estate and the Environment

Learning Objectives

After reading this chapter, you should understand the following:

- The various kinds of interests (or “estates”) in real property
- The various rights that come with ownership of real property
- What easements are, how they are created, and how they function
- How ownership of real property is regulated by tort law, by agreement, and by the public interest (through eminent domain)
- The various ways in which environmental laws affect the ownership and use of real property

Real property is an important part of corporate as well as individual wealth. As a consequence, the role of the corporate real estate manager has become critically important within the corporation. The real estate manager must be aware not only of the value of land for purchase and sale but also of proper lease negotiation, tax policies and assessments, zoning and land development, and environmental laws.

In this chapter, we focus on regulation of land use and the environment. We divide our discussion of the nature of real estate into three major categories: (1) estates; (2) rights that are incidental to the possession and ownership of land—for example, the right to air, water, and minerals; and (3) easements—the rights in lands of others.

16.1: Estates

16.2: Rights Incident to Possession and Ownership of Real Estate

16.3: Easements- Rights in the Lands of Others

16.4: Regulation of Land Use

16.5: Environmental Law

16.6: Cases

16.7: Summary and Exercises

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16.1: Estates

Learning Objectives

By the end of this section, you will be able to:

- Distinguish between the various kinds of estates, or interests, in real property that the law recognizes.

In property law, an estate is an interest in real property, ranging from absolute dominion and control to bare possession. Ordinarily when we think of property, we think of only one kind: absolute ownership. The owner of a car has the right to drive it where and when she wants, rebuild it, repaint it, and sell it or scrap it. The notion that the owner might lose her property when a particular event happens is foreign to our concept of personal property. Not so with real property. You would doubtless think it odd if you were sold a used car subject to the condition that you not paint it a different color—and that if you did, you would automatically be stripped of ownership. But land can be sold that way. Land and other real property can be divided into many categories of interests, as we will see. (Be careful not to confuse the various types of interests in real property with the forms of ownership, such as joint tenancy. An interest in real property that amounts to an estate is a measure of the degree to which a thing is owned; the form of ownership deals with the particular person or persons who own it.)

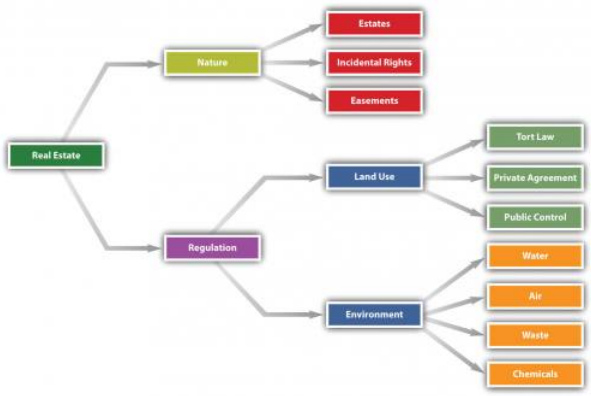


Figure 28.1 Chapter Overview

The common law distinguishes estates along two main axes: (1) freeholds versus leaseholds and (2) present versus future interests. A freehold estate is an interest in land that has an uncertain duration. The freehold can be outright ownership—called the fee simple absolute—or it can be an interest in the land for the life of the possessor; in either case, it is impossible to say exactly how long the estate will last. In the case of one who owns property outright, her estate will last until she sells or transfers it; in the case of a life estate, it will last until the death of the owner or another specified individual. A leasehold estate is one whose termination date is usually known. A one-year lease, for example, will expire precisely at the time stated in the lease agreement.

A present estate is one that is currently owned and enjoyed; a future estate is one that will come into the owner's possession upon the occurrence of a particular event. In this chapter, we consider both present and future freehold interests; leasehold interests we save for Chapter 32.

Present Estates (Freeholds)

Fee Simple Absolute

The strongest form of ownership is known as the fee simple absolute (or fee simple, or merely fee). This is what we think of when we say that someone "owns" the land. As one court put it, "The grant of a fee in land conveys to the grantee complete ownership, immediately and forever, with the right of possession from boundary to boundary and from the center of the earth to the sky, together with all the lawful uses thereof."*Magnolia Petroleum Co. v. Thompson*, 106 F.2d 217 (8th Cir. 1939). Although the fee simple may be encumbered by a mortgage (you may borrow money against the equity in your home) or an easement (you may grant someone the right to walk across your backyard), the underlying control is in the hands of the owner. Though it was once a complex matter in determining whether a person had been given a fee simple interest, today the law presumes that the estate being transferred is a fee simple, unless the conveyance expressly states to the contrary. (In her will, Lady Gaga grants her five-thousand-

acre ranch “to my screen idol, Tilda Swinton.” On the death of Lady Gaga, Swinton takes ownership of the ranch outright in fee simple absolute.)

Fee Simple Defeasible

Not every transfer of real property creates a fee simple absolute. Some transfers may limit the estate. Any transfer specifying that the ownership will terminate upon a particular happening is known as a fee simple defeasible. Suppose, for example, that Mr. Warbucks conveys a tract of land “to Miss Florence Nightingale, for the purpose of operating her hospital and for no other purpose. Conveyance to be good as long as hospital remains on the property.” This grant of land will remain the property of Miss Nightingale and her heirs as long as she and they maintain a hospital. When they stop doing so, the land will automatically revert to Mr. Warbucks or his heirs, without their having to do anything to regain title. Note that the conveyance of land could be perpetual but is not absolute, because it will remain the property of Miss Nightingale only so long as she observes the conditions in the grant.

Life Estates

An estate measured by the life of a particular person is called a life estate. A conventional life estate is created privately by the parties themselves. The simplest form is that conveyed by the following words: “to Scarlett for life.” Scarlett becomes a life tenant; as such, she is the owner of the property and may occupy it for life or lease it or even sell it, but the new tenant or buyer can acquire only as much as Scarlett has to give, which is ownership for her life (i.e., all she can sell is a life estate in the land, not a fee simple absolute). If Scarlett sells the house and dies a month later, the buyer’s interest would terminate. A life estate may be based on the life of someone other than the life tenant: “to Scarlett for the life of Rhett.”

The life tenant may use the property as though he were the owner in fee simple absolute with this exception: he may not act so as to diminish the value of the property that will ultimately go to the remainderman—the person who will become owner when the life estate terminates. The life tenant must pay the life estate for ordinary upkeep of the property, but the remainderman is responsible for extraordinary repairs.

Some life estates are created by operation of law and are known as legal life estates. The most common form is a widow’s interest in the real property of her husband. In about one-third of the states, a woman is entitled to dower, a right to a percentage (often one-third) of the property of her husband when he dies. Most of these states give a widower a similar interest in the property of his deceased wife. Dower is an alternative to whatever is bequeathed in the will; the widow has the right to elect the share stated in the will or the share available under dower. To prevent the dower right from upsetting the interests of remote purchasers, the right may be waived on sale by having the spouse sign the deed.

Future Estates

To this point, we have been considering present estates. But people also can have future interests in real property. Despite the implications of its name, the future interest is owned now but is not available to be used or enjoyed now. For the most part, future interests may be bought and sold, just as land held in fee simple absolute may be bought and sold. There are several classes of future interests, but in general there are two major types: reversion and remainder.

Reversion

A reversion arises whenever the estate transferred has a duration less than that originally owned by the transferor. A typical example of a simple reversion is that which arises when a life estate is conveyed. The ownership conveyed is only for the life; when the life tenant dies, the ownership interest reverts to the grantor. Suppose the grantor has died in the meantime. Who gets the reversion interest? Since the reversion is a class of property that is owned now, it can be inherited, and the grantor’s heirs would take the reversion at the subsequent death of the life tenant.

Remainder

The transferor need not keep the reversion interest for himself. He can give that interest to someone else, in which case it is known as a remainder interest, because the remainder of the property is being transferred. Suppose the transferor conveys land with these words: “to Scarlett for life and then to Rhett.” Scarlett has a life estate; the remainder goes to Rhett in fee simple absolute. Rhett is said to have a vested remainder interest, because on Scarlett’s death, he or his heirs will automatically become owners of the property. Some remainder interests are contingent—and are therefore known as contingent remainder interests—on the happening of a certain event: “to my mother for her life, then to my sister if she marries Harold before my mother dies.” The transferor’s sister

will become the owner of the property in fee simple only if she marries Harold while her mother is alive; otherwise, the property will revert to the transferor or his heirs. The number of permutations of reversions and remainders can become quite complex, far more than we have space to discuss in this text.

Key Takeaway

An estate is an interest in real property. Estates are of many kinds, but one generic difference is between ownership estates and possessory estates. Fee simple estates and life estates are ownership estates, while leasehold interests are possessory. Among ownership estates, the principal division is between present estates and future estates. An owner of a future estate has an interest that can be bought and sold and that will ripen into present possession at the end of a period of time, at the end of the life of another, or with the happening of some contingent event.

Exercises

1. Jessa owns a house and lot on 9th Avenue. She sells the house to the Hartley family, who wish to have a conveyance from her that says, “to Harriet Hartley for life, remainder to her son, Alexander Sandridge.” Alexander is married to Chloe, and they have three children, Carmen, Sarah, and Michael. Who has a future interest, and who has a present interest? What is the correct legal term for Harriet’s estate? Does Alexander, Carmen, Sarah, or Michael have any part of the estate at the time Jessa conveys to Harriet using the stated language?
2. After Harriet dies, Alexander wants to sell the property. Alexander and Chloe’s children are all eighteen years of age or older. Can he convey the property by his signature alone? Who else needs to sign?

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16.2: Rights Incident to Possession and Ownership of Real Estate

Learning Objectives

By the end of this section, you will be able to:

- Understand that property owners have certain rights in the airspace above their land, in the minerals beneath their land, and even in water that adjoins their land.

Rights to Airspace

The traditional rule was stated by Lord Coke: "Whoever owns the soil owns up to the sky." This traditional rule remains valid today, but its application can cause problems. A simple example would be a person who builds an extension to the upper story of his house so that it hangs out over the edge of his property line and thrusts into the airspace of his neighbor. That would clearly be an encroachment on the neighbor's property. But is it trespass when an airplane—or an earth satellite—flies over your backyard? Obviously, the courts must balance the right to travel against landowners' rights. In *U.S. v. Causby*,*U.S. v. Causby*, 328 U.S. 256 (1946). the Court determined that flights over private land may constitute a diminution in the property value if they are so low and so frequent as to be a direct and immediate interference with the enjoyment and use of land.

Rights to the Depths

Lord Coke's dictum applies to the depths as well as the sky. The owner of the surface has the right to the oil, gas, and minerals below it, although this right can be severed and sold separately. Perplexing questions may arise in the case of oil and gas, which can flow under the surface. Some states say that oil and gas can be owned by the owner of the surface land; others say that they are not owned until actually extracted—although the property owner may sell the exclusive right to extract them from his land. But states with either rule recognize that oil and gas are capable of being "captured" by drilling that causes oil or gas from under another plot of land to run toward the drilled hole. Since the possibility of capture can lead to wasteful drilling practices as everyone nearby rushes to capture the precious commodities, many states have enacted statutes requiring landowners to share the resources.

Rights to Water

The right to determine how bodies of water will be used depends on basic property rules. Two different approaches to water use in the United States—eastern and western—have developed over time (see Figure 28.2). Eastern states, where water has historically been more plentiful, have adopted the so-called riparian rights theory, which itself can take two forms. *Riparian* refers to land that includes a part of the bed of a waterway or that borders on a public watercourse. A riparian owner is one who owns such land. What are the rights of upstream and downstream owners of riparian land regarding use of the waters? One approach is the "natural flow" doctrine: Each riparian owner is entitled to have the river or other waterway maintained in its natural state. The upstream owner may use the river for drinking water or for washing but may not divert it to irrigate his crops or to operate his mill if doing so would materially change the amount of the flow or the quality of the water. Virtually all eastern states today are not so restrictive and rely instead on a "reasonable use" doctrine, which permits the benefit to be derived from use of the waterway to be weighed against the gravity of the harm. This approach is illustrated in *Hoover v. Crane*, (see Section 28.6.1 "Reasonable Use Doctrine".*Hoover v. Crane*, 362 Mich. 36, 106 N.W.2d 563 (1960).



Figure 28.2 Water Rights

In contrast to riparian rights doctrines, western states have adopted the prior appropriation doctrine. This rule looks not to equality of interests but to priority in time: first in time is first in right. The first person to use the water for a beneficial purpose has a right superior to latecomers. This rule applies even if the first user takes all the water for his own needs and even if other users are

riparian owners. This rule developed in water-scarce states in which development depended on incentives to use rather than hoard water. Today, the prior appropriation doctrine has come under criticism because it gives incentives to those who already have the right to the water to continue to use it profligately, rather than to those who might develop more efficient means of using it.

Key Takeaway

Property owners have certain rights in the airspace above their land. They also have rights in subsurface minerals, which include oil and gas. Those property owners who have bodies of water adjacent to their land will also have certain rights to withdraw or impound water for their own use. Regarding US water law, the reasonable use doctrine in the eastern states is distinctly different from the prior appropriation doctrine in western states.

Exercises

1. Steve Hannaford farms in western Nebraska. The farm has passed to succeeding generations of Hannafords, who use water from the North Platte River for irrigation purposes. The headlands of the North Platte are in Colorado, but use of the water from the North Platte by Nebraskans preceded use of the water by settlers in Colorado. What theory of water rights governs Nebraska and Colorado residents? Can the state of Colorado divert and use water in such a way that less of it reaches western Nebraska and the Hannaford farm? Why or why not?
2. Jamie Stoner decides to put solar panels on the south face of his roof. Jamie lives on a block of one- and two-bedroom bungalows in South Miami, Florida. In 2009, someone purchases the house next door and within two years decides to add a second and third story. This proposed addition will significantly decrease the utility of Jamie's solar array. Does Jamie have any rights that would limit what his new neighbors can do on their own land?

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16.3: Easements- Rights in the Lands of Others

Learning Objectives

By the end of this section, you will be able to:

- Explain the difference between an easement and a license.
- Describe the ways in which easements can be created.

Definition

An easement is an interest in land created by agreement that permits one person to make use of another's estate. This interest can extend to a profit, the taking of something from the other's land. Though the common law once distinguished between an easement and profit, today the distinction has faded, and profits are treated as a type of easement. An easement must be distinguished from a mere license, which is permission, revocable at the will of the owner, to make use of the owner's land. An easement is an estate; a license is personal to the grantee and is not assignable.

The two main types of easements are affirmative and negative. An affirmative easement gives a landowner the right to use the land of another (e.g., crossing it or using water from it), while a negative easement, by contrast, prohibits the landowner from using his land in ways that would affect the holder of the easement. For example, the builder of a solar home would want to obtain negative easements from neighbors barring them from building structures on their land that would block sunlight from falling on the solar home. With the growth of solar energy, some states have begun to provide stronger protection by enacting laws that regulate one's ability to interfere with the enjoyment of sunlight. These laws range from a relatively weak statute in Colorado, which sets forth rules for obtaining easements, to the much stronger statute in California, which says in effect that the owner of a solar device has a vested right to continue to receive the sunlight.

Another important distinction is made between easements appurtenant and easements in gross. An easement appurtenant benefits the owner of adjacent land. The easement is thus appurtenant to the holder's land. The benefited land is called the dominant tenement, and the burdened land—that is, the land subject to the easement—is called the servient tenement (see Figure 28.3). An easement in gross is granted independent of the easement holder's ownership or possession of land. It is simply an independent right—for example, the right granted to a local delivery service to drive its trucks across a private roadway to gain access to homes at the other end.

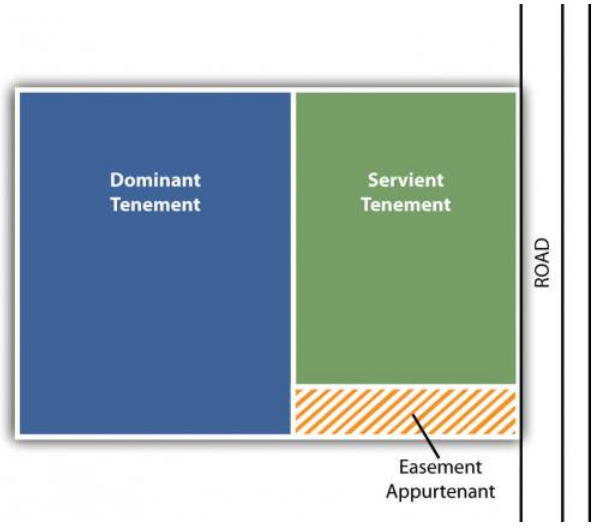


Figure 28.3 Easement Appurtenant

Unless it is explicitly limited to the grantee, an easement appurtenant "runs with the land." That is, when the dominant tenement is sold or otherwise conveyed, the new owner automatically owns the easement. A commercial easement in gross may be transferred —for instance, easements to construct pipelines, telegraph and telephone lines, and railroad rights of way. However, most noncommercial easements in gross are not transferable, being deemed personal to the original owner of the easement. Rochelle

sells her friend Mrs. Nanette—who does not own land adjacent to Rochelle—an easement across her country farm to operate skimobiles during the winter. The easement is personal to Mrs. Nanette; she could not sell the easement to anyone else.

Creation

Easements may be created by express agreement, either in deeds or in wills. The owner of the dominant tenement may buy the easement from the owner of the servient tenement or may reserve the easement for himself when selling part of his land. But courts will sometimes allow implied easements under certain circumstances. For instance, if the deed refers to an easement that bounds the premises—without describing it in any detail—a court could conclude that an easement was intended to pass with the sale of the property.

An easement can also be implied from prior use. Suppose a seller of land has two lots, with a driveway connecting both lots to the street. The only way to gain access to the street from the back lot is to use the driveway, and the seller has always done so. If the seller now sells the back lot, the buyer can establish an easement in the driveway through the front lot if the prior use was (1) apparent at the time of sale, (2) continuous, and (3) reasonably necessary for the enjoyment of the back lot. The rule of implied easements through prior use operates only when the ownership of the dominant and servient tenements was originally in the same person.

Use of the Easement

The servient owner may use the easement—remember, it is on or under or above his land—as long as his use does not interfere with the rights of the easement owner. Suppose you have an easement to walk along a path in the woods owned by your neighbor and to swim in a private lake that adjoins the woods. At the time you purchased the easement, your neighbor did not use the lake. Now he proposes to swim in it himself, and you protest. You would not have a sound case, because his swimming in the lake would not interfere with your right to do so. But if he proposed to clear the woods and build a mill on it, obliterating the path you took to the lake and polluting the lake with chemical discharges, then you could obtain an injunction to bar him from interfering with your easement.

The owner of the dominant tenement is not restricted to using his land as he was at the time he became the owner of the easement. The courts will permit him to develop the land in some “normal” manner. For example, an easement on a private roadway for the benefit of a large estate up in the hills would not be lost if the large estate were ultimately subdivided and many new owners wished to use the roadway; the easement applies to the entire portion of the original dominant tenement, not merely to the part that abuts the easement itself. However, the owner of an easement appurtenant to one tract of land cannot use the easement on another tract of land, even if the two tracts are adjacent.

Key Takeaway

An easement appurtenant runs with the land and benefits the dominant tenement, burdening the servient tenement. An easement, generally, has a specific location or description within or over the servient tenement. Easements can be created by deed, by will, or by implication.

Exercises

1. Beth Delaney owns property next to Kerry Plemmons. The deed to Delaney’s property notes that she has access to a well on the Plemmons property “to obtain water for household use.” The well has been dry for many generations and has not been used by anyone on the Plemmons property or the Delaney property for as many generations. The well predated Plemmons’s ownership of the property; as the servient tenement, the Plemmons property was burdened by this easement dating back to 1898. Plemmons hires a company to dig a very deep well near one of his outbuildings to provide water for his horses. The location is one hundred yards from the old well. Does the Delaney property have any easement to use water from the new well?

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16.4: Regulation of Land Use

Learning Objectives

By the end of this section, you will be able to:

- Compare the various ways in which law limits or restricts the right to use your land in any way that you decide is best for you.
- Distinguish between regulation by common law and regulation by public acts such as zoning or eminent domain.
- Understand that property owners may restrict the uses of land by voluntary agreement, subject to important public policy considerations.

Land use regulation falls into three broad categories: (1) restriction on the use of land through tort law, (2) private regulation by agreement, and (3) public ownership or regulation through the powers of eminent domain and zoning.

Regulation of Land Use by Tort Law

Tort law is used to regulate land use in two ways: (1) The owner may become liable for certain activities carried out on the real estate that affect others beyond the real estate. (2) The owner may be liable to persons who, upon entering the real estate, are injured.

Landowner's Activities

The two most common torts in this area are nuisance and trespass. A common-law nuisance is an interference with the use and enjoyment of one's land. Examples of nuisances are excessive noise (especially late at night), polluting activities, and emissions of noxious odors. But the activity must produce substantial harm, not fleeting, minor injury, and it must produce those effects on the reasonable person, not on someone who is peculiarly allergic to the complained-of activity. A person who suffered migraine headaches at the sight of croquet being played on a neighbor's lawn would not likely win a nuisance lawsuit. While the meaning of nuisance is difficult to define with any precision, this common-law cause of action is a primary means for landowners to obtain damages for invasive environmental harms.

A trespass is the wrongful physical invasion of or entry upon land possessed by another. Loud noise blaring out of speakers in the house next door might be a nuisance but could not be a trespass, because noise is not a physical invasion. But spraying pesticides on your gladiolas could constitute a trespass on your neighbor's property if the pesticide drifts across the boundary.

Nuisance and trespass are complex theories, a full explanation of which would consume far more space than we have. What is important to remember is that these torts are two-edged swords. In some situations, the landowner himself will want to use these theories to sue trespassers or persons creating a nuisance, but in other situations, the landowner will be liable under these theories for his own activities.

Injury to Persons Entering the Real Estate

Traditionally, liability for injury has depended on the status of the person who enters the real estate.

Trespassers

If the person is an intruder without permission—a trespasser—the landowner owes him no duty of care unless he knows of the intruder's presence, in which case the owner must exercise reasonable care in his activities and warn of hidden dangers on his land of which he is aware. A known trespasser is someone whom the landowner actually sees on the property or whom he knows frequently intrudes on the property, as in the case of someone who habitually walks across the land. If a landowner knows that people frequently walk across his property and one day he puts a poisonous chemical on the ground to eliminate certain insects, he is obligated to warn those who continue to walk on the grounds. Intentional injury to known trespassers is not allowed, even if the trespasser is a criminal intent on robbery, for the law values human life above property rights.

Children

If the trespasser is a child, a different rule applies in most states. This is the doctrine of attractive nuisance. Originally this rule was enunciated to deal with cases in which something on the land attracted the child to it, like a swimming pool. In recent years, most courts have dropped the requirement that the child must have been attracted to the danger. Instead, the following elements of proof are necessary to make out a case of attractive nuisance (Restatement of Torts, Section 339):

1. The child must have been injured by a structure or other artificial condition.
2. The possessor of the land (not necessarily the owner) must have known or should have known that young children would be likely to trespass.
3. The possessor must have known or should have known that the artificial condition exists and that it posed an unreasonable risk of serious injury.
4. The child must have been too young to appreciate the danger that the artificial condition posed.
5. The risk to the child must have far outweighed the utility of the artificial condition to the possessor.
6. The possessor did not exercise reasonable care in protecting the child or eliminating the danger.

Old refrigerators, open gravel pits, or mechanisms that a curious child would find inviting are all examples of attractive nuisance. Suppose Farmer Brown keeps an old buggy on his front lawn, accessible from the street. A five-year-old boy clambers up the buggy one day, falls through a rotted floorboard, and breaks his leg. Is Farmer Brown liable? Probably so. The child was too young to appreciate the danger posed by the buggy, a structure. The farmer should have appreciated that young children would be likely to come onto the land when they saw the buggy and that they would be likely to climb up onto the buggy. Moreover, he should have known, if he did not know in fact, that the buggy, left outside for years without being tended, would pose an unreasonable risk. The buggy's utility as a decoration was far overbalanced by the risk that it posed to children, and the farmer failed to exercise reasonable care.

Licensees

A nontrespasser who comes onto the land without being invited, or if invited, comes for purposes unconnected with any business conducted on the premises, is known as a licensee. This class of visitors to the land consists of (1) social guests (people you invite to your home for a party); (2) a salesman, not invited by the owner, who wishes to sell something to the owner or occupier of the property; and (3) persons visiting a building for a purpose not connected with the business on the land (e.g., students who visit a factory to see how it works). The landowner owes the same duty of care to licensees that he owes to known trespassers. That is, he must warn them against hidden dangers of which he is aware, and he must exercise reasonable care in his activities to ensure that they are not injured.

Invitees

A final category of persons entering land is that of invitee. This is one who has been invited onto the land, usually, though not necessarily, for a business purpose of potential economic benefit to the owner or occupier of the premises. This category is confusing because it sounds as though it should include social guests (who clearly are invited onto the premises), but traditionally social guests are said to be licensees.

Invitees include customers of stores, users of athletic and other clubs, customers of repair shops, strollers through public parks, restaurant and theater patrons, hotel guests, and the like. From the owner's perspective, the major difference between licensees and invitees is that he is liable for injuries resulting to the latter from hidden dangers that he should have been aware of, even if he is not actually aware of the dangers. How hidden the dangers are and how broad the owner's liability is depends on the circumstances, but liability sometimes can be quite broad. Difficult questions arise in lawsuits brought by invitees (or business invitees, as they are sometimes called) when the actions of persons other than the landowner contribute to the injury.

The foregoing rules dealing with liability for persons entering the land are the traditional rules at common law. In recent years, some courts have moved away from the rigidities and sometimes perplexing differences between trespassers, licensees, and invitees. By court decision, several states have now abolished such distinctions and hold the proprietor, owner, or occupier liable for failing to maintain the premises in a reasonably safe condition. According to the California Supreme Court,

A man's life or limb does not become less worthy of protection by the law nor a loss less worthy of compensation under the law because he has come upon the land of another without permission or with permission but without a business purpose. Reasonable

people do not ordinarily vary their conduct depending upon such matters, and to focus upon the status of the injured party as a trespasser, licensee, or invitee in order to determine the question whether the landowner has a duty of care, is contrary to our modern social mores and humanitarian values. Where the occupier of land is aware of a concealed condition involving in the absence of precautions an unreasonable risk of harm to those coming in contact with it and is aware that a person on the premises is about to come in contact with it, the trier of fact can reasonably conclude that a failure to warn or to repair the condition constitutes negligence. Whether or not a guest has a right to expect that his host will remedy dangerous conditions on his account, he should reasonably be entitled to rely upon a warning of the dangerous condition so that he, like the host, will be in a position to take special precautions when he comes in contact with it.*Rowland v. Christian*, 443 P.2d 561 (Cal. 1968).

Private Regulation of Land Use by Agreement

A restrictive covenant is an agreement regarding the use of land that "runs with the land." In effect, it is a contractual promise that becomes part of the property and that binds future owners. Violations of covenants can be redressed in court in suits for damages or injunctions but will not result in reversion of the land to the seller.

Usually, courts construe restrictive covenants narrowly—that is, in a manner most conducive to free use of the land by the ultimate owner (the person against whom enforcement of the covenant is being sought). Sometimes, even when the meaning of the covenant is clear, the courts will not enforce it. For example, when the character of a neighborhood changes, the courts may declare the covenant a nullity. Thus a restriction on a one-acre parcel to residential purposes was voided when in the intervening thirty years a host of businesses grew up around it, including a bowling alley, restaurant, poolroom, and sewage disposal plant.*Norris v. Williams*, 54 A.2d 331 (Md. 1947).

An important nullification of restrictive covenants came in 1947 when the US Supreme Court struck down as unconstitutional racially restrictive covenants, which barred blacks and other minorities from living on land so burdened. The Supreme Court reasoned that when a court enforces such a covenant, it acts in a discriminatory manner (barring blacks but not whites from living in a home burdened with the covenant) and thus violates the Fourteenth Amendment's guarantee of equal protection of the laws.*Shelley v. Kraemer*, 334 U.S. 1 (1947).

Public Control of Land Use through Eminent Domain

The government may take private property for public purposes. Its power to do so is known as eminent domain. The power of eminent domain is subject to constitutional limitations. Under the Fifth Amendment, the property must be put to public use, and the owner is entitled to "just compensation" for his loss. These requirements are sometimes difficult to apply.

Public Use

The requirement of public use normally means that the property will be useful to the public once the state has taken possession—for example, private property might be condemned to construct a highway. Although not allowed in most circumstances, the government could even condemn someone's property in order to turn around and sell it to another individual, if a legitimate public purpose could be shown. For example, a state survey in the mid-1960s showed that the government owned 49 percent of Hawaii's land. Another 47 percent was controlled by seventy-two private landowners. Because this concentration of land ownership (which dated back to feudal times) resulted in a critical shortage of residential land, the Hawaiian legislature enacted a law allowing the government to take land from large private estates and resell it in smaller parcels to homeowners. In 1984, the US Supreme Court upheld the law, deciding that the land was being taken for a public use because the purpose was "to attack certain perceived evils of concentrated property ownership."*Hawaii Housing Authority v. Midkiff*, 467 U.S. 229 (1984). Although the use must be public, the courts will not inquire into the necessity of the use or whether other property might have been better suited. It is up to government authorities to determine whether and where to build a road, not the courts.

The limits of public use were amply illustrated in the Supreme Court's 2002 decision of *Kelo v. New London*,*Kelo v. New London*, 545 U.S. 469 (2005). in which Mrs. Kelo's house was condemned so that the city of New London, in Connecticut, could create a marina and industrial park to lease to Pfizer Corporation. The city's motives were to create a higher tax base for property taxes. The Court, following precedent in *Midkiff* and other cases, refused to invalidate the city's taking on constitutional grounds. Reaction from states was swift; many states passed new laws restricting the bases for state and municipal governments to use powers of eminent domain, and many of these laws also provided additional compensation to property owners whose land was taken.

Just Compensation

The owner is ordinarily entitled to the fair market value of land condemned under eminent domain. This value is determined by calculating the most profitable use of the land at the time of the taking, even though it was being put to a different use. The owner will have a difficult time collecting lost profits; for instance, a grocery store will not usually be entitled to collect for the profits it might have made during the next several years, in part because it can presumably move elsewhere and continue to make profits and in part because calculating future profits is inherently speculative.

Taking

The most difficult question in most modern cases is whether the government has in fact "taken" the property. This is easy to answer when the government acquires title to the property through condemnation proceedings. But more often, a government action is challenged when a law or regulation inhibits the use of private land. Suppose a town promulgates a setback ordinance, requiring owners along city sidewalks to build no closer to the sidewalk than twenty feet. If the owner of a small store had only twenty-five feet of land from the sidewalk line, the ordinance would effectively prevent him from housing his enterprise, and the ordinance would be a taking. Challenging such ordinances can sometimes be difficult under traditional tort theories because the government is immune from suit in some of these cases. Instead, a theory of inverse condemnation has developed, in which the plaintiff private property owner asserts that the government has condemned the property, though not through the traditional mechanism of a condemnation proceeding.

Public Control of Land Use through Zoning

Zoning is a technique by which a city or other municipality regulates the type of activity to be permitted in geographical areas within its boundaries. Though originally limited to residential, commercial, and industrial uses, today's zoning ordinances are complex sets of regulations. A typical municipality might have the following zones: residential with a host of subcategories (such as for single-family and multiple-family dwellings), office, commercial, industrial, agricultural, and public lands. Zones may be exclusive, in which case office buildings would not be permitted in commercial zones, or they may be cumulative, so that a more restricted use would be allowed in a less restrictive zone. Zoning regulations do more than specify the type of use: they often also dictate minimum requirements for parking, open usable space, setbacks, lot sizes, and the like, and maximum requirements for height, length of side lots, and so on.

Nonconforming Uses

When a zoning ordinance is enacted, it will almost always affect existing property owners, many of whom will be using their land in ways no longer permitted under the ordinance. To avoid the charge that they have thereby "taken" the property, most ordinances permit previous nonconforming uses to continue, though some ordinances limit the nonconforming uses to a specified time after becoming effective. But this permission to continue a nonconforming use is narrow; it extends only to the specific use to which the property was put before the ordinance was enacted. A manufacturer of dresses that suddenly finds itself in an area zoned residential may continue to use its sewing machines, but it could not develop a sideline in woodworking.

Variances

Sometimes an owner may desire to use his property in ways not permitted under an existing zoning scheme and will ask the zoning board for a variance—authority to carry on a nonconforming use. The board is not free to grant a variance at its whim. The courts apply three general tests to determine the validity of a variance: (1) The land must be unable to yield a reasonable return on the uses allowed by the zoning regulation. (2) The hardship must be unique to the property, not to property generally in the area. (3) If granted, the variance must not change the essential character of the neighborhood.

Key Takeaway

Land use regulation can mean (1) restrictions on the use of land through tort law, (2) private regulation—by agreement, or (3) regulation through powers of eminent domain or zoning.

Exercises

1. Give one example of the exercise of eminent domain. In order to exercise its power under eminent domain, must the government actually take eventual ownership of the property that is "taken"?

2. Felix Unger is an adult, trespassing for the first time on Alan Spillborghs's property. Alan has been digging a deep grave in his backyard for his beloved Saint Bernard, Maximilian, who has just died. Alan stops working on the grave when it gets dark, intending to return to the task in the morning. He seldom sees trespassers cutting through his backyard. Felix, in the dark, after visiting the local pub, decides to take a shortcut through Alan's yard and falls into the grave. He breaks his leg. What is the standard of care for Alan toward Felix or other infrequent trespassers? If Alan has no insurance for this accident, would the law make Alan responsible?
3. Atlantic Cement owns and operates a cement plant in New York State. Nearby residents are exposed to noise, soot, and dust and have experienced lowered property values as a result of Atlantic Cement's operations. Is there a common-law remedy for nearby property owners for losses occasioned by Atlantic's operations? If so, what is it called?

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16.5: Environmental Law

Learning Objectives

By the end of this section, you will be able to:

- Describe the major federal laws that govern business activities that may adversely affect air quality and water quality.
- Describe the major federal laws that govern waste disposal and chemical hazards including pesticides.

In one sense, environmental law is very old. Medieval England had smoke control laws that established the seasons when soft coal could be burned. Nuisance laws give private individuals a limited control over polluting activities of adjacent landowners. But a comprehensive set of US laws directed toward general protection of the environment is largely a product of the past quarter-century, with most of the legislative activity stemming from the late 1960s and later, when people began to perceive that the environment was systematically deteriorating from assaults by rapid population growth and greatly increased automobile driving, vast proliferation of factories that generate waste products, and a sharp rise in the production of toxic materials. Two of the most significant developments in environmental law came in 1970, when the National Environmental Policy Act took effect and the Environmental Protection Agency became the first of a number of new federal administrative agencies to be established during the decade.

National Environmental Policy Act

Signed into law by President Nixon on January 1, 1970, the National Environmental Policy Act (NEPA) declared that it shall be the policy of the federal government, in cooperation with state and local governments, "to create and maintain conditions under which man and nature can exist in productive harmony, and fulfill the social, economic, and other requirements of present and future generations of Americans.…The Congress recognizes that each person should enjoy a healthful environment and that each person has a responsibility to contribute to the preservation and enhancement of the environment."42 United States Code, Section 4321 et seq.

The most significant aspect of NEPA is its requirement that federal agencies prepare an environmental impact statement in every recommendation or report on proposals for legislation and whenever undertaking a major federal action that significantly affects environmental quality. The statement must (1) detail the environmental impact of the proposed action, (2) list any unavoidable adverse impacts should the action be taken, (3) consider alternatives to the proposed action, (4) compare short-term and long-term consequences, and (5) describe irreversible commitments of resources. Unless the impact statement is prepared, the project can be enjoined from proceeding. Note that NEPA does not apply to purely private activities but only to those proposed to be carried out in some manner by federal agencies.

Environmental Protection Agency

The Environmental Protection Agency (EPA) has been in the forefront of the news since its creation in 1970. Charged with monitoring environmental practices of industry, assisting the government and private business to halt environmental deterioration, promulgating regulations consistent with federal environmental policy, and policing industry for violations of the various federal environmental statutes and regulations, the EPA has had a pervasive influence on American business. *Business Week* noted the following in 1977: "Cars rolling off Detroit's assembly line now have antipollution devices as standard equipment. The dense black smokestack emissions that used to symbolize industrial prosperity are rare, and illegal, sights. Plants that once blithely ran discharge water out of a pipe and into a river must apply for permits that are almost impossible to get unless the plants install expensive water treatment equipment. All told, the EPA has made a sizable dent in man-made environmental filth.""The Tricks of the Trade-off," *Business Week*, April 4, 1977, 72.

The EPA is especially active in regulating water and air pollution and in overseeing the disposition of toxic wastes and chemicals. To these problems we now turn.

Water Pollution

Clean Water Act

Legislation governing the nation's waterways goes back a long time. The first federal water pollution statute was the Rivers and Harbors Act of 1899. Congress enacted new laws in 1948, 1956, 1965, 1966, and 1970. But the centerpiece of water pollution enforcement is the Clean Water Act of 1972 (technically, the Federal Water Pollution Control Act Amendments of 1972), as amended in 1977 and by the Water Quality Act of 1987. The Clean Water Act is designed to restore and maintain the "chemical, physical, and biological integrity of the Nation's waters."33 United States Code, Section 1251. It operates on the states, requiring them to designate the uses of every significant body of water within their borders (e.g., for drinking water, recreation, commercial fishing) and to set water quality standards to reduce pollution to levels appropriate for each use.

Congress only has power to regulate interstate commerce, and so the Clean Water Act is applicable only to "navigable waters" of the United States. This has led to disputes over whether the act can apply, say, to an abandoned gravel pit that has no visible connection to navigable waterways, even if the gravel pit provides habitat for migratory birds. In *Solid Waste Agency of Northern Cook County v. Army Corps of Engineers*, the US Supreme Court said no.*Solid Waste Agency of Northern Cook County v. Army Corps of Engineers*, 531 U.S. 159 (2001).

Private Industry

The Clean Water Act also governs private industry and imposes stringent standards on the discharge of pollutants into waterways and publicly owned sewage systems. The act created an effluent permit system known as the National Pollutant Discharge Elimination System. To discharge any pollutants into navigable waters from a "point source" like a pipe, ditch, ship, or container, a company must obtain a certification that it meets specified standards, which are continually being tightened. For example, until 1983, industry had to use the "best practicable technology" currently available, but after July 1, 1984, it had to use the "best available technology" economically achievable. Companies must limit certain kinds of "conventional pollutants" (such as suspended solids and acidity) by "best conventional control technology."

Other EPA Water Activities

Federal law governs, and the EPA regulates, a number of other water control measures. Ocean dumping, for example, is the subject of the Marine Protection, Research, and Sanctuaries Act of 1972, which gives the EPA jurisdiction over wastes discharged into the oceans. The Clean Water Act gives the EPA and the US Army Corps of Engineers authority to protect waters, marshlands, and other wetlands against degradation caused by dredging and fills. The EPA also oversees state and local plans for restoring general water quality to acceptable levels in the face of a host of non-point-source pollution. The Clean Water Act controls municipal sewage systems, which must ensure that wastewater is chemically treated before being discharged from the sewage system.

Obviously, of critical importance to the nation's health is the supply of drinking water. To ensure its continuing purity, Congress enacted the Safe Drinking Water Act of 1974, with amendments passed in 1986 and 1996. This act aims to protect water at its sources: rivers, lakes, reservoirs, springs, and groundwater wells. (The act does not regulate private wells that serve fewer than twenty-five individuals.) This law has two strategies for combating pollution of drinking water. It establishes national standards for drinking water derived from both surface reservoirs and underground aquifers. It also authorizes the EPA to regulate the injection of solid wastes into deep wells (as happens, for instance, by leakage from underground storage tanks).

Air Pollution

The centerpiece of the legislative effort to clean the atmosphere is the Clean Air Act of 1970 (amended in 1975, 1977, and 1990). Under this act, the EPA has set two levels of National Ambient Air Quality Standards (NAAQS). The primary standards limit the ambient (i.e., circulating) pollution that affects human health; secondary standards limit pollution that affects animals, plants, and property. The heart of the Clean Air Act is the requirement that subject to EPA approval, the states implement the standards that the EPA establishes. The setting of these pollutant standards was coupled with directing the states to develop state implementation plans (SIPs), applicable to appropriate industrial sources in the state, in order to achieve these standards. The act was amended in 1977 and 1990 primarily to set new goals (dates) for achieving attainment of NAAQS since many areas of the country had failed to meet the deadlines.

Beyond the NAAQS, the EPA has established several specific standards to control different types of air pollution. One major type is pollution that mobile sources, mainly automobiles, emit. The EPA requires new cars to be equipped with catalytic converters and to use unleaded gasoline to eliminate the most noxious fumes and to keep them from escaping into the atmosphere. To minimize pollution from stationary sources, the EPA also imposes uniform standards on new industrial plants and those that have been substantially modernized. And to safeguard against emissions from older plants, states must promulgate and enforce SIPs.

The Clean Air Act is even more solicitous of air quality in certain parts of the nation, such as designated wilderness areas and national parks. For these areas, the EPA has set standards to prevent significant deterioration in order to keep the air as pristine and clear as it was centuries ago.

The EPA also worries about chemicals so toxic that the tiniest quantities could prove fatal or extremely hazardous to health. To control emission of substances like asbestos, beryllium, mercury, vinyl chloride, benzene, and arsenic, the EPA has established or proposed various National Emissions Standards for Hazardous Air Pollutants.

Concern over acid rain and other types of air pollution prompted Congress to add almost eight hundred pages of amendments to the Clean Air Act in 1990. (The original act was fifty pages long.) As a result of these amendments, the act was modernized in a manner that parallels other environmental laws. For instance, the amendments established a permit system that is modeled after the Clean Water Act. And the amendments provide for felony convictions for willful violations, similar to penalties incorporated into other statutes.

The amendments include certain defenses for industry. Most important, companies are protected from allegations that they are violating the law by showing that they were acting in accordance with a permit. In addition to this "permit shield," the law also contains protection for workers who unintentionally violate the law while following their employers' instructions.

Waste Disposal

Though pollution of the air by highly toxic substances like benzene or vinyl chloride may seem a problem removed from that of the ordinary person, we are all in fact polluters. Every year, the United States generates approximately 230 million tons of "trash"—about 4.6 pounds per person per day. Less than one-quarter of it is recycled; the rest is incinerated or buried in landfills. But many of the country's landfills have been closed, either because they were full or because they were contaminating groundwater. Once groundwater is contaminated, it is extremely expensive and difficult to clean it up. In the 1965 Solid Waste Disposal Act and the 1970 Resource Recovery Act, Congress sought to regulate the discharge of garbage by encouraging waste management and recycling. Federal grants were available for research and training, but the major regulatory effort was expected to come from the states and municipalities.

But shocking news prompted Congress to get tough in 1976. The plight of homeowners near Love Canal in upstate New York became a major national story as the discovery of massive underground leaks of toxic chemicals buried during the previous quarter century led to evacuation of hundreds of homes. Next came the revelation that Kepone, an exceedingly toxic pesticide, had been dumped into the James River in Virginia, causing a major human health hazard and severe damage to fisheries in the James and downstream in the Chesapeake Bay. The rarely discussed industrial dumping of hazardous wastes now became an open controversy, and Congress responded in 1976 with the Resource Conservation and Recovery Act (RCRA) and the Toxic Substances Control Act (TSCA) and in 1980 with the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA).

Resource Conservation and Recovery Act

The RCRA expresses a "cradle-to-grave" philosophy: hazardous wastes must be regulated at every stage. The act gives the EPA power to govern their creation, storage, transport, treatment, and disposal. Any person or company that generates hazardous waste must obtain a permit (known as a "manifest") either to store it on its own site or ship it to an EPA-approved treatment, storage, or disposal facility. No longer can hazardous substances simply be dumped at a convenient landfill. Owners and operators of such sites must show that they can pay for damage growing out of their operations, and even after the sites are closed to further dumping, they must set aside funds to monitor and maintain the sites safely.

This philosophy can be severe. In 1986, the Supreme Court ruled that bankruptcy is not a sufficient reason for a company to abandon toxic waste dumps if state regulations reasonably require protection in the interest of public health or safety. The practical effect of the ruling is that trustees of the bankrupt company must first devote assets to cleaning up a dump site, and only from remaining assets may they satisfy creditors.*Midlantic National Bank v. New Jersey*, 474 U.S. 494 (1986). Another severity is

RCRA's imposition of criminal liability, including fines of up to $25,000 a day and one-year prison sentences, which can be extended beyond owners to individual employees, as discussed in *U.S. v. Johnson & Towers, Inc., et al.*, (see Section 28.6.2 "Criminal Liability of Employees under RCRA").

Comprehensive Environmental Response, Compensation, and Liability Act

The CERCLA, also known as the Superfund, gives the EPA emergency powers to respond to public health or environmental dangers from faulty hazardous waste disposal, currently estimated to occur at more than seventeen thousand sites around the country. The EPA can direct immediate removal of wastes presenting imminent danger (e.g., from train wrecks, oil spills, leaking barrels, and fires). Injuries can be sudden and devastating; in 1979, for example, when a freight train derailed in Florida, ninety thousand pounds of chlorine gas escaped from a punctured tank car, leaving 8 motorists dead and 183 others injured and forcing 3,500 residents within a 7-mile radius to be evacuated. The EPA may also carry out "planned removals" when the danger is substantial, even if immediate removal is not necessary.

The EPA prods owners who can be located to voluntarily clean up sites they have abandoned. But if the owners refuse, the EPA and the states will undertake the task, drawing on a federal trust fund financed mainly by taxes on the manufacture or import of certain chemicals and petroleum (the balance of the fund comes from general revenues). States must finance 10 percent of the cost of cleaning up private sites and 50 percent of the cost of cleaning up public facilities. The EPA and the states can then assess unwilling owners' punitive damages up to triple the cleanup costs.

Cleanup requirements are especially controversial when applied to landowners who innocently purchased contaminated property. To deal with this problem, Congress enacted the Superfund Amendment and Reauthorization Act in 1986, which protects innocent landowners who—at the time of purchase—made an "appropriate inquiry" into the prior uses of the property. The act also requires companies to publicly disclose information about hazardous chemicals they use. We now turn to other laws regulating chemical hazards.

Chemical Hazards

Toxic Substances Control Act

Chemical substances that decades ago promised to improve the quality of life have lately shown their negative side—they have serious adverse side effects. For example, asbestos, in use for half a century, causes cancer and asbestosis, a debilitating lung disease, in workers who breathed in fibers decades ago. The result has been crippling disease and death and more than thirty thousand asbestos-related lawsuits filed nationwide. Other substances, such as polychlorinated biphenyls (PCBs) and dioxin, have caused similar tragedy. Together, the devastating effects of chemicals led to enactment of the TSCA, designed to control the manufacture, processing, commercial distribution, use, and disposal of chemicals that pose unreasonable health or environmental risks. (The TSCA does not apply to pesticides, tobacco, nuclear materials, firearms and ammunition, food, food additives, drugs, and cosmetics—all are regulated by other federal laws.)

The TSCA gives the EPA authority to screen for health and environmental risks by requiring companies to notify the EPA ninety days before manufacturing or importing new chemicals. The EPA may demand that the companies test the substances before marketing them and may regulate them in a number of ways, such as requiring the manufacturer to label its products, to keep records on its manufacturing and disposal processes, and to document all significant adverse reactions in people exposed to the chemicals. The EPA also has authority to ban certain especially hazardous substances, and it has banned the further production of PCBs and many uses of asbestos.

Both industry groups and consumer groups have attacked the TSCA. Industry groups criticize the act because the enforcement mechanism requires mountainous paperwork and leads to widespread delay. Consumer groups complain because the EPA has been slow to act against numerous chemical substances. The debate continues.

Pesticide Regulation

The United States is a major user of pesticides, substances that eliminate troublesome insects, rodents, fungi, and bacteria, consuming more than a billion pounds a year in the form of thirty-five thousand separate chemicals. As useful as they can be, like many chemical substances, pesticides can have serious side effects on humans and plant and animal life. Beginning in the early

1970s, Congress enacted major amendments to the Federal Insecticide, Fungicide, and Rodenticide Act of 1947 and the Federal Food, Drug, and Cosmetic Act (FFDCA) of 1906.

These laws direct the EPA to determine whether pesticides properly balance effectiveness against safety. If the pesticide can carry out its intended function without causing unreasonable adverse effects on human health or the environment, it may remain on the market. Otherwise, the EPA has authority to regulate or even ban its distribution and use. To enable the EPA to carry out its functions, the laws require manufacturers to provide a wealth of data about the way individual pesticides work and their side effects. The EPA is required to inspect pesticides to ensure that they conform to their labeled purposes, content, and safety, and the agency is empowered to certify pesticides for either general or restricted use. If a pesticide is restricted, only those persons certified in approved training programs may use it. Likewise, under the Pesticide Amendment to the FFDCA, the EPA must establish specific tolerances for the residue of pesticides on feed crops and both raw and processed foods. The Food and Drug Administration (for agricultural commodities) and the US Department of Agriculture (for meat, poultry, and fish products) enforce these provisions.

Other Types of Environmental Controls

Noise Regulation

Under the Noise Regulation Act of 1972, Congress has attempted to combat a growing menace to US workers, residents, and consumers. People who live close to airports and major highways, workers who use certain kinds of machinery (e.g., air compressors, rock drills, bulldozers), and consumers who use certain products, such as power mowers and air conditioners, often suffer from a variety of ailments. The Noise Regulation Act delegates to the EPA power to limit “noise emissions” from these major sources of noise. Under the act, manufacturers may not sell new products that fail to conform to the noise standards the EPA sets, and users are forbidden from dismantling noise control devices installed on these products. Moreover, manufacturers must label noisy products properly. Private suits may be filed against violators, and the act also permits fines of up to $25,000 per day and a year in jail for those who seek to avoid its terms.

Radiation Controls

The terrifying effects of a nuclear disaster became frighteningly clear when the Soviet Union’s nuclear power plant at Chernobyl exploded in early 1986, discharging vast quantities of radiation into the world’s airstream and affecting people thousands of miles away. In the United States, the most notorious nuclear accident occurred at the Three Mile Island nuclear utility in Pennsylvania in 1979, crippling the facility for years because of the extreme danger and long life of the radiation. Primary responsibility for overseeing nuclear safety rests with the Nuclear Regulatory Commission, but many other agencies and several federal laws (including the Clean Air Act; the Federal Water Pollution Control Act; the Safe Drinking Water Act; the Uranium Mill Tailings Radiation Control Act; the Marine Protection, Research, and Sanctuaries Act; the Nuclear Waste Policy Act of 1982; the CERCLA; and the Ocean Dumping Act) govern the use of nuclear materials and the storage of radioactive wastes (some of which will remain severely dangerous for thousands of years). Through many of these laws, the EPA has been assigned the responsibility of setting radiation guidelines, assessing new technology, monitoring radiation in the environment, setting limits on release of radiation from nuclear utilities, developing guidance for use of X-rays in medicine, and helping to plan for radiation emergencies.

Key Takeaway

Laws limiting the use of one’s property have been around for many years; common-law restraints (e.g., the law of nuisance) exist as causes of action against those who would use their property to adversely affect the life or health of others or the value of their neighbors’ property. Since the 1960s, extensive federal laws governing the environment have been enacted. These include laws governing air, water, chemicals, pesticides, solid waste, and nuclear activities. Some laws include criminal penalties for noncompliance.

Exercises

1. Who is responsible for funding CERCLA? That is, what is the source of funds for cleanups of hazardous waste?
2. Why is it necessary to have criminal penalties for noncompliance with environmental laws?
3. What is the role of states in setting standards for clean air and clean water?
4. Which federal act sets up a “cradle-to-grave” system for handling waste?

5. Why are federal environmental laws necessary? Why not let the states exclusively govern in the area of environmental protection?

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16.6: Cases

Reasonable Use Doctrine

Hoover v. Crane

362 Mich. 36, 106 N.W.2d 563 (1960)

EDWARDS, JUSTICE

This appeal represents a controversy between plaintiff cottage and resort owners on an inland Michigan lake and defendant, a farmer with a fruit orchard, who was using the lake water for irrigation. The chancellor who heard the matter ruled that defendant had a right to reasonable use of lake water. The decree defined such reasonable use in terms which were unsatisfactory to plaintiffs who have appealed.

The testimony taken before the chancellor pertained to the situation at Hutchins Lake, in Allegan county, during the summer of 1958. Defendant is a fruit farmer who owns a 180-acre farm abutting on the lake. Hutchins Lake has an area of 350 acres in a normal season. Seventy-five cottages and several farms, including defendant's, abut on it. Defendant's frontage is approximately 1/4 mile, or about 10% of the frontage of the lake.

Hutchins Lake is spring fed. It has no inlet but does have an outlet which drains south. Frequently in the summertime the water level falls so that the flow at the outlet ceases.

All witnesses agreed that the summer of 1958 was exceedingly dry and plaintiffs' witnesses testified that Hutchins Lake's level was the lowest it had ever been in their memory. Early in August, defendant began irrigation of his 50-acre pear orchard by pumping water out of Hutchins Lake. During that month the lake level fell 6 to 8 inches—the water line receded 50 to 60 feet and cottagers experienced severe difficulties with boating and swimming.

* * *

The tenor of plaintiffs' testimony was to attribute the 6- to 8-inch drop in the Hutchins Lake level in that summer to defendant's irrigation activities. Defendant contended that the decrease was due to natural causes, that the irrigation was of great benefit to him and contributed only slightly to plaintiff's discomfiture. He suggests to us:

One could fairly say that because plaintiffs couldn't grapple with the unknown causes that admittedly occasioned a greater part of the injury complained of, they chose to grapple mightily with the defendant because he is known and visible.

The circuit judge found it impossible to determine a normal lake level from the testimony, except that the normal summer level of the lake is lower than the level at which the lake ceases to drain into the outlet. He apparently felt that plaintiffs' problems were due much more to the abnormal weather conditions of the summer of 1958 than to defendant's irrigation activities.

His opinion concluded:

Accepting the reasonable use theory advanced by plaintiffs it appears to the court that the most equitable disposition of this case would be to allow defendant to use water from the lake until such time when his use interferes with the normal use of his neighbors. One quarter inch of water from the lake ought not to interfere with the rights and uses of defendant's neighbors and this quantity of water ought to be sufficient in time of need to service 45 acres of pears. A meter at the pump, sealed if need be, ought to be a sufficient safeguard. Pumping should not be permitted between the hours of 11 p.m. and 7 a.m. Water need be metered only at such times as there is no drainage into the outlet.

The decree in this suit may provide that the case be kept open for the submission of future petitions and proofs as the conditions permit or require.

* * *

Michigan has adopted the reasonable-use rule in determining the conflicting rights of riparian owners to the use of lake water.

In 1874, Justice COOLEY said:

It is therefore not a diminution in the quantity of the water alone, or an alteration in its flow, or either or both of these circumstances combined with injury, that will give a right of action, if in view of all the circumstances, and having regard to

equality of right in others, that which has been done and which causes the injury is not unreasonable. In other words, the injury that is incidental to a reasonable enjoyment of the common right can demand no redress. *Dumont* v. *Kellogg*, 29 Mich 420, 425.

And in *People* v. *Hulbert*, the Court said:

No statement can be made as to what is such reasonable use which will, without variation or qualification, apply to the facts of every case. But in determining whether a use is reasonable we must consider what the use is for; its extent, duration, necessity, and its application; the nature and size of the stream, and the several uses to which it is put; the extent of the injury to the one proprietor and of the benefit to the other; and all other facts which may bear upon the reasonableness of the use. *Red River Roller Mills* v. *Wright*, 30 Minn 249, 15 NW 167, and cases cited.

The Michigan view is in general accord with 4 Restatement, Torts, §§ 851–853.

* * *

We interpret the circuit judge's decree as affording defendant the total metered equivalent in pumpage of 1/4 inch of the content of Hutchins Lake to be used in any dry period in between the cessation of flow from the outlet and the date when such flow recommences. Where the decree also provides for the case to be kept open for future petitions based on changed conditions, it would seem to afford as much protection for plaintiffs as to the future as this record warrants.

Both resort use and agricultural use of the lake are entirely legitimate purposes. Neither serves to remove water from the watershed. There is, however, no doubt that the irrigation use does occasion some water loss due to increased evaporation and absorption. Indeed, extensive irrigation might constitute a threat to the very existence of the lake in which all riparian owners have a stake; and at some point the use of the water which causes loss must yield to the common good.

The question on this appeal is, of course, whether the chancellor's determination of this point was unreasonable as to plaintiffs. On this record, we cannot overrule the circuit judge's view that most of plaintiffs' 1958 plight was due to natural causes. Nor can we say, if this be the only irrigation use intended and the only water diversion sought, that use of the amount provided in the decree during the dry season is unreasonable in respect to other riparian owners.

Affirmed.

? Case Questions

1. If the defendant has caused a diminution in water flow, an alteration of the water flow, and the plaintiff is adversely affected, why would the Supreme Court of Michigan not provide some remedy?
2. Is it possible to define an injury that is "not unreasonable"?
3. Would the case even have been brought if there had not been a drought?

More Reasonable Use Doctrine

U.S. v. Johnson & Towers, Inc., Jack W. Hopkins, and Peter Angel

741 F.2d 662 (1984)

SLOVITER, Circuit Judge

Before us is the government's appeal from the dismissal of three counts of an indictment charging unlawful disposal of hazardous wastes under the Resource Conservation and Recovery Act. In a question of first impression regarding the statutory definition of "person," the district court concluded that the Act's criminal penalty provision imposing fines and imprisonment could not apply to the individual defendants. We will reverse.

The criminal prosecution in this case arose from the disposal of chemicals at a plant owned by Johnson & Towers in Mount Laurel, New Jersey. In its operations the company, which repairs and overhauls large motor vehicles, uses degreasers and other industrial chemicals that contain chemicals such as methylene chloride and trichlorethylene, classified as "hazardous wastes" under the Resource Conservation and Recovery Act (RCRA), 42 U.S.C. §§ 6901–6987 (1982) and "pollutants" under the Clean Water Act, 33 U.S.C. §§ 1251–1376 (1982). During the period relevant here, the waste chemicals from cleaning operations were drained into a holding tank and, when the tank was full, pumped into a trench. The trench flowed from the plant property into Parker's Creek, a tributary of the Delaware River. Under RCRA, generators of such wastes must obtain a permit for disposal from the Environmental

Protection Agency (E.P.A.). The E.P.A. had neither issued nor received an application for a permit for Johnson & Towers' operations.

The indictment named as defendants Johnson & Towers and two of its employees, Jack Hopkins, a foreman, and Peter Angel, the service manager in the trucking department. According to the indictment, over a three-day period federal agents saw workers pump waste from the tank into the trench, and on the third day observed toxic chemicals flowing into the creek.

Count 1 of the indictment charged all three defendants with conspiracy under 18 U.S.C. § 371 (1982). Counts 2, 3, and 4 alleged violations under the RCRA criminal provision, 42 U.S.C. § 6928(d) (1982). Count 5 alleged a violation of the criminal provision of the Clean Water Act, 33 U.S.C. § 1319(c) (1982). Each substantive count also charged the individual defendants as aiders and abettors under 18 U.S.C. § 2 (1982).

The counts under RCRA charged that the defendants "did knowingly treat, store, and dispose of, and did cause to be treated, stored and disposed of hazardous wastes without having obtained a permit…in that the defendants discharged, deposited, injected, dumped, spilled, leaked and placed degreasers…into the trench.…" The indictment alleged that both Angel and Hopkins "managed, supervised and directed a substantial portion of Johnson & Towers' operations…including those related to the treatment, storage and disposal of the hazardous wastes and pollutants" and that the chemicals were discharged by "the defendants and others at their direction." The indictment did not otherwise detail Hopkins' and Angel's activities or responsibilities.

Johnson & Towers pled guilty to the RCRA counts. Hopkins and Angel pled not guilty, and then moved to dismiss counts 2, 3, and 4. The court concluded that the RCRA criminal provision applies only to "owners and operators," i.e., those obligated under the statute to obtain a permit. Since neither Hopkins nor Angel was an "owner" or "operator," the district court granted the motion as to the RCRA charges but held that the individuals could be liable on these three counts under 18 U.S.C. § 2 for aiding and abetting. The court denied the government's motion for reconsideration, and the government appealed to this court under 18 U.S.C. § 3731 (1982).

* * *

The single issue in this appeal is whether the individual defendants are subject to prosecution under RCRA's criminal provision, which applies to:

any person who—

….

(2) knowingly treats, stores, or disposes of any hazardous waste identified or listed under this subchapter either—

(A) without having obtained a permit under section 6925 of this title…or

(B) in knowing violation of any material condition or requirement of such permit.

42 U.S.C. § 6928(d) (emphasis added). The permit provision in section 6925, referred to in section 6928(d), requires "each person owning or operating a facility for the treatment, storage, or disposal of hazardous waste identified or listed under this subchapter to have a permit" from the E.P.A.

The parties offer contrary interpretations of section 6928(d)(2)(A). Defendants consider it an administrative enforcement mechanism, applying only to those who come within section 6925 and fail to comply; the government reads it as penalizing anyone who handles hazardous waste without a permit or in violation of a permit. Neither party has cited another case, nor have we found one, considering the application of this criminal provision to an individual other than an owner or operator.

As in any statutory analysis, we are obliged first to look to the language and then, if needed, attempt to divine Congress' specific intent with respect to the issue.

First, "person" is defined in the statute as "an individual, trust, firm, joint stock company, corporation (including a government corporation), partnership, association, State, municipality, commission, political subdivision of a State, or any interstate body." 42 U.S.C. § 6903(15) (1982). Had Congress meant in section 6928(d)(2)(A) to take aim more narrowly, it could have used more narrow language. Since it did not, we attribute to "any person" the definition given the term in section 6903(15).

Second, under the plain language of the statute the only explicit basis for exoneration is the existence of a permit covering the action. Nothing in the language of the statute suggests that we should infer another provision exonerating persons who knowingly

treat, store or dispose of hazardous waste but are not owners or operators.

Finally, though the result may appear harsh, it is well established that criminal penalties attached to regulatory statutes intended to protect public health, in contrast to statutes based on common law crimes, are to be construed to effectuate the regulatory purpose.

* * *

Congress enacted RCRA in 1976 as a "cradle-to-grave" regulatory scheme for toxic materials, providing "nationwide protection against the dangers of improper hazardous waste disposal." H.R. Rep. No. 1491, 94th Cong., 2d Sess. 11, *reprinted in* 1976 U.S. Code Cong. & Ad. News 6238, 6249. RCRA was enacted to provide "a multifaceted approach toward solving the problems associated with the 3–4 billion tons of discarded materials generated each year, and the problems resulting from the anticipated 8% annual increase in the volume of such waste." *Id.* at 2, 1976 U.S. Code Cong. & Ad. News at 6239. The committee reports accompanying legislative consideration of RCRA contain numerous statements evincing the Congressional view that improper disposal of toxic materials was a serious national problem.

The original statute made knowing disposal (but not treatment or storage) of such waste without a permit a misdemeanor. Amendments in 1978 and 1980 expanded the criminal provision to cover treatment and storage and made violation of section 6928 a felony. The fact that Congress amended the statute twice to broaden the scope of its substantive provisions and enhance the penalty is a strong indication of Congress' increasing concern about the seriousness of the prohibited conduct.

We conclude that in RCRA, no less than in the Food and Drugs Act, Congress endeavored to control hazards that, "in the circumstances of modern industrialism, are largely beyond self-protection." *United States v. Dotterweich*, 320 U.S. at 280. It would undercut the purposes of the legislation to limit the class of potential defendants to owners and operators when others also bear responsibility for handling regulated materials. The phrase "without having obtained a permit *under section 6925*" (emphasis added) merely references the section under which the permit is required and exempts from prosecution under section 6928(d)(2)(A) anyone who has obtained a permit; we conclude that it has no other limiting effect. Therefore we reject the district court's construction limiting the substantive criminal provision by confining "any person" in section 6928(d)(2)(A) to owners and operators of facilities that store, treat or dispose of hazardous waste, as an unduly narrow view of both the statutory language and the congressional intent.

? Case Questions

1. The district court (trial court) accepted the individual defendants' argument. What was that argument?
2. On what reasoning did the appellate court reject that argument?
3. If employees of a company that is violating the RCRA carry out disposal of hazardous substances in violation of the RCRA, they would presumably lose their jobs if they didn't. What is the moral justification for applying criminal penalties to such employees (such as Hopkins and Angel)?

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16.7: Summary and Exercises

Summary

An estate is an interest in real property; it is the degree to which a thing is owned. Freehold estates are those with an uncertain duration; leaseholds are estates due to expire at a definite time. A present estate is one that is currently owned; a future estate is one that is owned now but not yet available for use.

Present estates are (1) the fee simple absolute; (2) the fee simple defeasible, which itself may be divided into three types, and (3) the life estate.

Future estates are generally of two types: reversion and remainder. A reversion arises whenever a transferred estate will endure for a shorter time than that originally owned by the transferor. A remainder interest arises when the transferor gives the reversion interest to someone else.

Use of air, earth, and water are the major rights incident to ownership of real property. Traditionally, the owner held “up to the sky” and “down to the depths,” but these rules have been modified to balance competing rights in a modern economy. The law governing water rights varies with the states; in general, the eastern states with more plentiful water have adopted either the natural flow doctrine or the reasonable use doctrine of riparian rights, giving those who live along a waterway certain rights to use the water. By contrast, western states have tended to apply the prior appropriation doctrine, which holds that first in time is first in right, even if those downstream are disadvantaged.

An easement is an interest in land—created by express agreement, prior use, or necessity—that permits one person to make use of another’s estate. An affirmative easement gives one person the right to use another’s land; a negative easement prevents the owner from using his land in a way that will affect another person’s land. In understanding easement law, the important distinctions are between easements appurtenant and in gross, and between dominant and servient owners.

The law not only defines the nature of the property interest but also regulates land use. Tort law regulates land use by imposing liability for (1) activities that affect those off the land and (2) injuries caused to people who enter it. The two most important theories relating to the former are nuisance and trespass. With respect to the latter, the common law confusingly distinguishes among trespassers, licensees, and invitees. Some states are moving away from the perplexing and rigid rules of the past and simply require owners to maintain their property in a reasonably safe condition.

Land use may also be regulated by private agreement through the restrictive covenant, an agreement that “runs with the land” and that will be binding on any subsequent owner. Land use is also regulated by the government’s power under eminent domain to take private land for public purposes (upon payment of just compensation), through zoning laws, and through recently enacted environmental statutes, including the National Environmental Policy Act and laws governing air, water, treatment of hazardous wastes, and chemicals.

Exercises

1. Dorothy deeded an acre of real estate that she owns to George for the life of Benny and then to Ernie. Describe the property interests of George, Benny, Ernie, and Dorothy.
2. In Exercise 1, assume that George moves into a house on the property. During a tornado, the roof is destroyed and a window is smashed. Who is responsible for repairing the roof and window? Why?
3. Dennis likes to spend his weekends in his backyard, shooting his rifle across his neighbor’s yard. If Dennis never sets foot on his neighbor’s property, and if the bullets strike neither persons nor property, has he violated the legal rights of the neighbor? Explain.
4. Dennis also drills an oil well in his backyard. He “slant drills” the well; that is, the well slants from a point on the surface in his yard to a point four hundred feet beneath the surface of his neighbor’s yard. Dennis has slanted the drilling in order to capture his neighbor’s oil. Can he do this legally? Explain.
5. Wanda is in charge of acquisitions for her company. Realizing that water is important to company operations, Wanda buys a plant site on a river, and the company builds a plant that uses all of the river water. Downstream owners bring suit to stop the company from using any water. What is the result? Why?

6. Sunny decides to build a solar home. Before beginning construction, she wants to establish the legal right to prevent her neighbors from constructing buildings that will block the sunlight. She has heard that the law distinguishes between licenses and easements, easements appurtenant and in gross, and affirmative and negative easements. Which of these interests would you recommend for Sunny? Why?

SELF CHECK QUESTIONS

1. A freehold estate is defined as an estate
    1. with an uncertain duration
    2. due to expire at a definite time
    3. owned now but not yet available for use
    4. that is leased or rented
2. A fee simple defeasible is a type of
    1. present estate
    2. future estate
    3. life estate
    4. leasehold estate
3. A reversion is
    1. a present estate that prevents transfer of land out of the family
    2. a form of life estate
    3. a future estate that arises when the estate transferred has a duration less than that originally owned by the transferor
    4. identical to a remainder interest
4. An easement is an interest in land that may be created by
    1. express agreement
    2. prior use
    3. necessity
    4. all of the above
5. The prior appropriation doctrine
    1. tends to be applied by eastern states
    2. holds that first in time is first in right
    3. gives those that live along a waterway special rights to use the water
    4. all of the above

AnswerS

1. a
2. a
3. c
4. d
5. b

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