BUSINESS LAW I



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1: INTRODUCTION TO LAW AND LEGAL SYSTEMS

Learning Objectives

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

1. Distinguish different philosophies of law—schools of legal thought—and explain their relevance.
2. Identify the various aims that a functioning legal system can serve.
3. Explain how politics and law are related.
4. Identify the sources of law and which laws have priority over other laws.
5. Understand some basic differences between the US legal system and other legal systems.

Law has different meanings as well as different functions. Philosophers have considered issues of justice and law for centuries, and several different approaches, or schools of legal thought, have emerged. In this chapter, we will look at those different meanings and approaches and will consider how social and political dynamics interact with the ideas that animate the various schools of legal thought. We will also look at typical sources of "positive law" in the United States and how some of those sources have priority over others, and we will set out some basic differences between the US legal system and other legal systems.

1.1: What Is Law?

1.2: Schools of Legal Thought

1.3: Basic Concepts and Categories of US Positive Law

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1.1: What Is Law?

What Is the Law?

The term *law* can mean different things depending on context. Black's Law Dictionary defines law as "a body of rules of action or conduct prescribed by controlling authority, and having binding legal force. That which must be obeyed and followed by citizens subject to sanctions or legal consequence is a law." (*Black's Law Dictionary*, 6th ed.).

Functions of the Law

In a nation, law can serve to:

1. Keep the peace
2. Maintain the status quo
3. Preserve individual rights
4. Protect minorities against majorities
5. Promote social justice
6. Provide for orderly social change

Some legal systems fulfill these functions better than others. For example, authoritarian governments may succeed in keeping the peace and maintaining order but often do so at the expense of minority rights and social justice.

Colonialism historically provides a clear example. European nations such as Britain, France, Spain, Portugal, and Belgium imposed borders and governments on colonized territories, often ignoring ethnic, cultural, or tribal divisions. While colonial powers used law and force to keep the peace, they disrupted the status quo and seldom promoted the rights of native populations.

Even after colonial rule ended, legal systems in post-colonial nations often faced challenges. In Rwanda, longstanding ethnic divisions between Hutus and Tutsis culminated in the 1994 genocide. In the former Yugoslavia, competing claims to territory among Croats, Bosniaks, and Serbs led to violent conflict in the 1990s. In Iraq and Afghanistan, efforts to create unified governments have been complicated by the need to balance power among different tribes, sects, and ethnic groups.

More recently, Russia's invasion of Ukraine in 2022 demonstrates how law, politics, and military power intersect globally. While international law condemns the violation of sovereignty and aggression, enforcement depends on political will, alliances, and power dynamics between states.

Law and Politics

In the United States, law is shaped by a variety of actors: legislators, judges, administrative agencies, governors, presidents, corporations, lobbyists, and advocacy groups such as the American Petroleum Institute, the Sierra Club, and the National Rifle Association.

Judicial appointments also highlight the intersection of law and politics. In many states, judges are elected, often in increasingly partisan campaigns. At the federal level, judges are nominated by the president and confirmed by the Senate, and the process can become highly politicized—especially when the presidency and Senate are controlled by different parties. The contentious confirmations of Supreme Court Justices Neil Gorsuch (2017), Brett Kavanaugh (2018), and Amy Coney Barrett (2020) illustrate how ideological divisions shape legal institutions.

Globally, lawmaking and enforcement often depend on political power and, in some cases, military force. Revolutions, protests, and political movements—whether the Arab Spring uprisings of the 2010s or the pro-democracy demonstrations in Hong Kong—show that struggles over who holds legal and political authority remain central to societies worldwide.

KEY TAKEAWAY

Law is the result of political action, and the political landscape is vastly different from nation to nation. Unstable or authoritarian governments often fail to serve the principal functions of law.

EXERCISES

1. Consider Burma (named Myanmar by its military rulers). What political rights do you have that the average Burmese citizen does not?
2. What is a nongovernment organization, and what does it have to do with government? Do you contribute to (or are you active in) a nongovernment organization? What kind of rights do they espouse, what kind of laws do they support, and what kind of laws do they oppose?

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1.2: Schools of Legal Thought

LEARNING OBJECTIVES

1. Distinguish different philosophies of law—schools of legal thought—and explain their relevance.
2. Explain why natural law relates to the rights that the founders of the US political-legal system found important.
3. Describe legal positivism and explain how it differs from natural law.
4. Differentiate critical legal studies and ecofeminist legal perspectives from both natural law and legal positivist perspectives.

Schools of Legal Thought

The study of law's philosophy is called **jurisprudence**. Different schools of thought answer the basic question: *What is law really about?* Two of the most influential are **legal positivism** and **natural law**, but there are others that continue to shape modern debates.

Legal Positivism: Law as Sovereign Command

Legal positivists argue that *law is valid if it comes from a recognized authority and can be enforced by that authority*. As legal philosopher John Austin said, "Law is the command of a sovereign."

- **Example (U.S. law):** The posted highway speed limit is law because it is enacted by the state and enforced by police. Whether we agree with it or not, it carries legal force.
- **Example (international):** When governments impose restrictions—such as pandemic lockdowns—those rules become "law" if enacted through proper authority, even if debated as unfair.

Positivists emphasize describing *what the law is*, not whether it is good or moral. Critics point out that this can lead to unjust results. For example, under Taliban rule in Afghanistan, laws that restricted women's education and healthcare were enforced with the full force of the state. Positivists would still call these "laws," while natural-law thinkers would question their legitimacy.

Natural Law

The **natural law** school argues that law should be grounded in universal moral principles—ideas of right and wrong that exist beyond government commands. These can come from reason, human dignity, or divine authority.

- **Example (historic):** The U.S. Declaration of Independence proclaims that all people are endowed with "unalienable Rights" such as *life, liberty, and the pursuit of happiness*.
- **Example (modern):** International human rights law, such as the UN Universal Declaration of Human Rights, reflects natural-law thinking. Even if a government denies free speech or bans peaceful protest, natural-law advocates argue those rights cannot be legitimately taken away.

Civil disobedience—refusing to obey unjust laws—has deep natural-law roots.

- **Rosa Parks (1955):** Refused to give up her seat under segregation laws.
- **Martin Luther King Jr. (1963):** In his "Letter from Birmingham Jail," he wrote that disobeying an unjust law is a moral act that shows "the highest respect for law."

Other Schools of Legal Thought

1. **Historical School** – Emphasizes that today's laws should reflect traditions and precedents. Stability and continuity matter more than moral ideals.

- *Example:* Using English common law principles as the basis for U.S. property law.

2. **Legal Realism** – Argues that laws must evolve with society. What judges *actually do* (influenced by their context, beliefs, and social change) matters more than what written statutes say.
   - *Example:* Courts adapting privacy law in the digital age (e.g., decisions about cell phone searches or data tracking).
3. **Critical Legal Studies (CLS)** – Claims that law is not neutral but serves the interests of those in power—wealthy individuals, corporations, and elites.
   - *Example:* Critics argue that corporate lobbying in Congress shapes laws that favor business interests over consumer protection.
4. **Ecofeminism** – Connects legal dominance of men over women with exploitation of nature. Ecofeminists see parallels between patriarchal ownership of land, historical exclusion of women from legal rights, and environmental destruction.
   - *Example:* Debates over climate justice, where women and marginalized groups disproportionately bear the burden of environmental harm.

KEY TAKEAWAY

Each school of legal thought offers a distinct perspective on the nature and purpose of law. Natural law emphasizes universal moral principles and the rights and duties of both government and the governed, while legal positivism views law as the command of a recognized sovereign authority that must be obeyed, regardless of morality. Critical Legal Studies (CLS) highlights how law has historically reinforced the dominance of the wealthy and powerful, and ecofeminist legal theory focuses on how law reflects and sustains patterns of male domination over both women and the natural environment. Taken together, these perspectives show that law can be understood either as neutral rules to be obeyed or as systems deeply shaped by morality, power, and social structures.

EXERCISES

1. Vandana Shiva draws a picture of a stream in a forest. She says that in our society the stream is seen as unproductive if it is simply there, fulfilling the need for water of women's families and communities, until engineers come along and tinker with it, perhaps damming it and using it for generating hydropower. The same is true of a forest, unless it is replaced with a monoculture plantation of a commercial species. A forest may very well be productive—protecting groundwater; creating oxygen; providing fruit, fuel, and craft materials for nearby inhabitants; and creating a habitat for animals that are also a valuable resource. She criticizes the view that if there is no monetary amount that can contribute to gross domestic product, neither the forest nor the river can be seen as a productive resource. Which school of legal thought does her criticism reflect?
2. Anatole France said, "The law, in its majesty, forbids rich and poor alike from sleeping under bridges." Which school of legal thought is represented by this quote?
3. Adolf Eichmann was a loyal member of the National Socialist Party in the Third Reich and worked hard under Hitler's government during World War II to round up Jewish people for incarceration—and eventual extermination—at labor camps like Auschwitz and Buchenwald. After an Israeli "extraction team" took him from Argentina to Israel, he was put on trial for "crimes against humanity." His defense was that he was "just following orders." Explain why Eichmann was not an adherent of the natural-law school of legal thought.

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1.3: Basic Concepts and Categories of US Positive Law

LEARNING OBJECTIVES

1. In a general way, differentiate contract law from tort law.
2. Consider the role of law in supporting ethical norms in our society.
3. Understand the differing roles of state law and federal law in the US legal system.
4. Know the difference between criminal cases and civil cases.

Most of what we discuss in this book is positive law—US positive law in particular. We will also consider the laws and legal systems of other nations. But first, it will be useful to cover some basic concepts and distinctions.

Law: The Moral Minimums in a Democratic Society

The law does not attempt to correct every wrong that occurs in society. Instead, it provides boundaries by addressing the most serious wrongs—those that violate what might be called the "moral minimums" that a community requires of its members. These include criminal offenses, torts, and breaches of contract. For example, it may be rude to ignore a friend's phone call, but that is not a legal matter. By contrast, using a phone or the Internet to spread false and damaging statements about another person constitutes libel or slander, both of which are actionable torts.

There is often a strong connection between what we consider ethical behavior and what the law enforces. Contract law reflects society's view that promises should generally be kept, though not every broken promise is legally actionable. Tort law embodies the principle that harming others is wrong and provides remedies when serious injury occurs, thereby preventing disorder and anarchy. Similarly, property law protects private ownership, which is generally seen as useful and desirable. While owners have wide latitude to use their property, the law limits that use when it harms the public—for example, burning toxic materials that spread hazardous ash into a neighborhood.

The Common Law: Property, Torts, and Contracts

Before legislatures existed, disputes still arose, and judges resolved them. In England, judges began recording cases and reasoning by analogy to past decisions. Over time, this reliance on precedent gave rise to the doctrine of **stare decisis**, meaning "let the decision stand." Courts applying this principle ensure consistency in the law by following established rulings when deciding new cases.

Most common-law decisions not based on statutes involve three main areas: **property, contracts, and torts**. Property law concerns the rights and duties of landowners, including buying, selling, leasing, and various legal interests in land. Contract law determines which promises courts will enforce—for example, whether a contract signed by a minor or someone intoxicated is valid. Tort law addresses civil wrongs that cause harm outside of contracts, such as defamation or unfair business practices.

The American colonies adopted English common law long before independence, and it continued to influence U.S. courts after the Revolution. Today, though courts rarely cite centuries-old English cases, state courts often rely on each other's rulings, especially when faced with a "case of first impression," a situation they have never encountered before. However, once a state's highest court has issued a ruling on a legal issue, lower courts in that state are bound to follow it.

State Courts and the Domain of State Law

Historically, state courts held primary jurisdiction over most areas of business and personal law, such as:

- Contracts, sales, and secured transactions
- Torts
- Real and personal property
- Corporations and partnerships
- Domestic relations (marriage, divorce, custody)

- Estates and inheritance
- Trademarks and copyrights
- Insurance and banking
- Environmental and agency law

Over the past century, however, federal law has expanded its role, particularly in areas like banking, securities, and environmental regulation, creating greater overlap between state and federal authority.

Civil versus Criminal Cases

This text focuses primarily on **civil law**, though criminal law is also significant for businesses. In criminal cases, the government prosecutes individuals or companies for violating laws that define society's moral minimums. Penalties can include fines, imprisonment, or even death in capital cases. In contrast, civil cases involve disputes between private parties, with remedies usually involving money damages or equitable relief rather than imprisonment.

For example, Ford Motor Company was ordered to pay $295 million in a civil personal injury case, while Texaco faced a $10.54 billion judgment in a dispute with Pennzoil. Neither case involved jail time, but both resulted in significant financial consequences. Thus, while criminal law enforces society's strictest standards by punishing violations, civil law provides remedies when private rights are infringed.

Some of the basic differences between **civil law** and **criminal law** cases are illustrated in Table 1.1.

Table 1.1 Differences between Civil and Criminal Cases

Differences between Civil and Criminal Cases

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

Regarding plaintiffs and prosecutors, you can often tell a civil case from a criminal case by looking at the caption of a case going to trial. If the government appears first in the caption of the case (e.g., *U.S. v. Lieberman*, it is likely that the United States is prosecuting on behalf of the people. The same is true of cases prosecuted by state district attorneys (e.g., *State v. Seidel*). But this is not a foolproof formula. Governments will also bring civil actions to collect debts from or settle disputes with individuals, corporations, or other governments. Thus *U.S. v. Mayer* might be a collection action for unpaid taxes, or *U.S. v. Canada* might be a boundary dispute in the International Court of Justice. Governments can be sued, as well; people occasionally sue their state or federal government, but they can only get a trial if the government waives its sovereign immunity and allows such suits. *Warner v. U.S.*, for example, could be a claim for a tax refund wrongfully withheld or for damage caused to the Warner residence by a sonic boom from a US Air Force jet flying overhead.

Substance versus Procedure Law

Laws in the United States fall broadly into two categories: **substantive laws** and **procedural laws**.

Substantive law consists of the actual rules of conduct that govern behavior between individuals, organizations, and the government. These rules direct citizens on how they must act or prohibit certain actions altogether. For example, substantive laws include:

- Do not drive more than fifty-five miles per hour where that speed limit is posted.
- Do not conspire to fix prices with competitors in the U.S. market.
- Do not falsely represent the curative effects of an over-the-counter herbal remedy.
- Do not drive through an intersection when a red traffic signal faces your direction.
- Do not discriminate against job applicants or employees based on race, sex, religion, or national origin.
- Do not discharge certain pollutants into a river without first obtaining a permit.

These rules define rights, duties, and prohibitions in everyday life.

Procedural law, by contrast, establishes the processes by which substantive laws are enforced. It governs how courts and administrative agencies operate, setting the steps for resolving disputes. For example, imagine you are ticketed for driving fifty-three miles per hour in a forty-mile-per-hour zone. The substantive law you violated is the posted speed limit. But questions about how your case is handled—who speaks first in court, whether you have the right to an attorney, what kinds of evidence are admissible, and how long the state has to prosecute—are all governed by procedural law.

Procedural questions could include:

- Is the officer's testimony enough, or do you get to contest it before a judge?
- Can radar evidence be admitted, and if so, must the officer be trained in its use?
- Does the officer's visual observation count, and if so, what qualifications are required?
- Could statements you made to friends outside the incident, like bragging about speeding years ago, be introduced as evidence?

Because procedural rules determine fairness in the legal process, the **Constitution provides safeguards**. The **Fourteenth Amendment's Due Process Clause** requires that state laws be fair whenever they deprive someone of "life, liberty, or property." Likewise, the **Fifth Amendment** imposes the same requirement on federal law. Even a $500 speeding fine qualifies as a deprivation of property, so the process by which it is imposed must meet constitutional standards of fairness.

This distinction shows that while substantive law tells us *what we can and cannot do*, procedural law tells us *how disputes are resolved when those rules are broken*.

KEY TAKEAWAY

In most legal systems, like that in the United States, there is a fairly firm distinction between criminal law (for actions that are offenses against the entire society) and civil law (usually for disputes between individuals or corporations). Basic ethical norms for promise-keeping and not harming others are reflected in the civil law of contracts and torts. In the United States, both the states and the federal government have roles to play, and sometimes these roles will overlap, as in environmental standards set by both states and the federal government.

EXERCISES

1. Jenna gets a ticket for careless driving after the police come to investigate a car accident she had with you on Hanover Boulevard. Your car is badly damaged through no fault of your own. Is Jenna likely to face criminal charges, civil charges, or both?
2. Jenna's ticket says that she has thirty days in which to respond to the charges against her. The thirty days conforms to a state law that sets this time limit. Is the thirty-day limit procedural law or substantive law?

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1.4: Sources of Law and Their Priority

LEARNING OBJECTIVES

1. Describe the different sources of law in the US legal system and the principal institutions that create those laws.
2. Explain in what way a statute is like a treaty, and vice versa.
3. Explain why the Constitution is "prior" and has priority over the legislative acts of a majority, whether in the US Congress or in a state legislature.
4. Describe the origins of the common-law system and what common law means.

Sources of Law

In the United States, law comes from several places. The principal sources are (1) **constitutions** (state and federal), (2) **statutes and agency regulations**, and (3) **judicial decisions**. In addition, chief executives (the President and state governors) may issue **executive orders** with the force of law.

Beyond U.S. borders, **international law** is shaped by **treaties** (agreements among nations) and **customary international law** (widely accepted practices and judicial decisions across nations).

Because these sources overlap, **conflicts** can arise: a state law may clash with a federal statute, or a federal statute may be in tension with U.S. treaty obligations. Not all laws are equal in authority. Understanding which rules **prevail** requires a sense of the **hierarchy** among legal sources.

Constitutions

Constitutions are a legal system's foundation, establishing the **legislative, executive, and judicial** framework. The United States has the world's oldest written national constitution still in force. It is intentionally **hard to amend**: after the first ten amendments (the Bill of Rights) in 1789, only seventeen more have been added, requiring two-thirds approval in both houses of Congress and ratification by three-fourths of the states.

Each **state** also has its own constitution. State constitutions may grant **rights beyond** those in the federal Constitution and can provide a **cause of action** for lawsuits. For example, California's constitution recognizes a **right of privacy**, which has supported employee-privacy claims against private employers (see *Rulon-Miller v. IBM*, 1984).

Statutes and Treaties in Congress

The federal legislature—**Congress**—has two chambers: the **House of Representatives** (seats apportioned by population; every state has at least one) and the **Senate** (two senators per state, regardless of population). Bills are drafted, assigned to **committees**, and may be debated, amended, and voted upon. Because House and Senate procedures differ, versions of a bill often diverge; a **conference committee** reconciles them. Identical language must pass both chambers before the bill goes to the **President** for signature or veto (which Congress can override by a two-thirds vote in each chamber).

Treaties—negotiated by the executive—require **Senate ratification** and then have the **same force as federal statutes**. Federal statutes are codified in the **U.S. Code**.

Delegated Lawmaking: Administrative Agencies

Congress (and state legislatures) often **delegate authority** to create and enforce detailed rules to **administrative agencies** (e.g., OSHA, EPA, FTC). Although the Constitution does not expressly mention agencies, the Supreme Court has upheld such

delegations so long as Congress provides an **intelligible principle**—guiding standards—rather than handing off its power wholesale.

Agencies publish proposed rules in the **Federal Register** and final rules in the **Code of Federal Regulations (CFR)**. Within the scope of delegated authority, **regulations carry the same force** as statutes.

State Statutes and Local Ordinances

States enact **statutes** through their legislatures (often a house and a senate) and governors may sign or veto bills. States also authorize **local governments** (counties, cities, townships) to enact **ordinances** on matters such as zoning, building codes, and local offenses. These rules must remain **consistent** with state and federal law.

Judicial Decisions: The Common Law

Common law consists of **court-made rules** developed when no statute or regulation controls. Rooted in English tradition, common law relies on **precedent** and the doctrine of **stare decisis** ("let the decision stand"): courts strive for consistency by following earlier, similar decisions.

Historically, courts defined crimes and private-law doctrines (property, contracts, torts). Over time, legislatures **codified** many of these areas, demonstrating a key principle of **priority**: when a valid statute addresses an issue, it **controls** over inconsistent common-law rules.

Priority of Laws

Constitutional Supremacy

The **U.S. Constitution** is supreme. Any statute, regulation, or judicial decision inconsistent with the Constitution is **void**. (For example, a state law banning non-defamatory criticism of professors at public universities would violate the **First Amendment**.)

Statutes vs. Cases

Statutes generally **supersede** conflicting **case law**. For instance, the **Fair Labor Standards Act (1938)** replaced common-law rules by setting a **minimum wage**, **overtime** requirements, and prohibiting **oppressive child labor**.

Treaties and the "Last-in-Time" Rule

A **treaty** has the **same status** as a federal statute. When a treaty and statute conflict, the one **adopted later** typically controls (the **last-in-time** rule). For example, trade agreements (formerly **NAFTA**, now the **USMCA**) can require changes to earlier laws or practices that conflict with treaty commitments. Likewise, decisions under the **WTO** dispute system may highlight tensions between U.S. statutes and international obligations, prompting Congress or agencies to adjust rules to maintain compliance—or, politically, to reconsider the commitment.

> **Note:** The United States may **withdraw** from treaties, but as long as it remains a party, those obligations stand as federal law.

Causes of Action, Precedent, and Stare Decisis

Courts do not remedy every perceived wrong. A plaintiff must identify a **cause of action** grounded in **positive law**—the Constitution, a statute, a regulation, a treaty, or prior case law. If Harold Hill promises to buy seventy-six trombones and doesn't

pay on delivery, you likely have a **contract claim**, unless a recognized defense applies (e.g., legal incapacity, mistake, or material late delivery).

Not every slight is actionable. The maxim **de minimis non curat lex** ("the law does not concern itself with trifles") reminds us that embarrassment over a missed date is not grounds for suit; by contrast, some states (but not most) have recognized **breach of promise to marry**. Whether a claim exists depends on the **jurisdiction's positive law**.

Because judges build on earlier decisions, **precedent** matters. Courts typically follow their jurisdiction's highest court under **stare decisis**, creating predictability. But courts can **distinguish** prior cases or **carve exceptions** when facts or policy differ (e.g., a general at-will employment rule can yield to a **public policy** exception when an employee is fired for refusing to commit **perjury**).

Reading judicial opinions—pinpointing the **issue**, the **holding** (the court's answer necessary to decide the case), and the **reasoning**—cultivates legal analysis. Judges often disagree (reflecting differing **schools of legal thought**), which is why **concurring** and **dissenting** opinions are common, especially in appellate courts.

Key Takeaway

U.S. law draws from multiple sources that stand in a **hierarchy**. The **Constitution** is supreme; **federal statutes** and **treaties** share equal rank (with the **last-in-time** rule resolving conflicts between them); valid **regulations** carry the force of law within delegated bounds; and **common law** governs when no statute or regulation applies. States mirror this structure with their own constitutions, statutes, regulations, and case law, all subject to federal supremacy. To bring a successful lawsuit, a party must tie the claim to a **recognized cause of action** in positive law.

EXERCISES

1. Give one example of where common law was overridden by the passage of a federal statute.
2. How does common law change or evolve without any action on the part of a legislature?
3. Lindsey Paradise is not selected for her sorority of choice at the University of Kansas. She has spent all her time rushing that particular sorority, which chooses some of her friends but not her. She is disappointed and angry and wants to sue the sorority. What are her prospects of recovery in the legal system? Explain.

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1.5: Legal and Political Systems of the World

LEARNING OBJECTIVE

1. Describe how the common-law system differs from the civil-law system.

Other legal and political systems are very different from the US system, which came from English common-law traditions and the framers of the US Constitution. Our legal and political traditions are different both in what kinds of laws we make and honor and in how disputes are resolved in court.

Comparing Common-Law Systems with Other Legal Systems

The **common-law tradition** is unique to England, the United States, and many former colonies of the British Empire. While differences exist among these nations—for example, not all allow their courts to declare legislative acts unconstitutional, and many use juries less frequently—they all rely on **precedent**: judicial decisions from earlier cases help guide later ones. By contrast, **civil-law systems** center on comprehensive legislative codes rather than case law.

Civil-Law Systems

The main alternative to common law is the **civil-law** or **code-law system**, which originated in Europe from **Roman law** and was reshaped during **Napoleon's reign**. Napoleon's government created a comprehensive legal code for France that addressed **criminal law, criminal procedure, civil law and procedure, and commercial law**.

Civil-law systems rely on **codes**, not judicial opinions, as the primary source of law. Judges decide cases by applying the written code rather than by following prior cases. Juries are rare, and judicial reasoning typically plays a smaller role than in common-law systems.

As Professor George Cameron of the University of Michigan observed, *"The law is in the code, not in the cases."* While French courts sometimes adopt a consistent interpretation of a code provision under the doctrine of *jurisprudence constante*, the main source of legal change is the **legislature**, not the courts.

Today, civil-law systems are used throughout **continental Europe** and much of **Central and South America**. Some nations in **Asia** and **Africa** also follow civil-law traditions, often introduced through European colonial rule. For example, French, Spanish, Portuguese, and Dutch colonies carried civil-law structures into their legal systems, just as England exported common law to the American colonies.

A Note on Terminology

Be careful not to confuse "civil law" in the European sense with **civil law vs. criminal law** in the U.S. context. In the United States, "civil law" usually means private disputes (contracts, torts, property) as opposed to criminal prosecution. But in Europe, "civil law" refers to the **entire legal tradition** based on codes, covering both civil and criminal matters.

Other Legal Traditions

Not all legal systems fit neatly into the common-law or civil-law categories.

- **Communist or socialist legal systems** (e.g., Cuba, North Korea) operate on principles quite different from those of Western democracies, often subordinating private rights to state planning and ideology.
- **Islamic law (Sharia)** and other **religion-based systems** emphasize values drawn from sacred texts and traditions, shaping

rules for both personal conduct and commercial dealings. These systems can coexist with, or stand alongside, secular codes, depending on the nation.

KEY TAKEAWAY

Legal systems vary widely in their aims and in the way they process civil and criminal cases. Common-law systems use juries, have one judge, and adhere to precedent. Civil-law systems decide cases without a jury, often use three judges, and often render shorter opinions without reference to previously decided cases.

EXERCISE

1. Use the Internet to identify some of the better-known nations with civil-law systems. Which Asian nations came to adopt all or part of civil-law traditions, and why?

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1.6: A Sample Case

Preliminary Note to Students

Title VII of the Civil Rights Act of 1964 is a federal statute that applies to all employers whose workforce exceeds fifteen people. The text of Title VII says that

(a) it shall be an unlawful employment practice for an employer—

(1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or natural origin.

At common law—where judges decide cases without reference to statutory guidance—employers were generally free to hire and fire on any basis they might choose, and employees were generally free to work for an employer or quit an employer on any basis they might choose (unless the employer and the employee had a contract). This rule has been called "employment at will." State and federal statutes that prohibit discrimination on any basis (such as the prohibitions on discrimination because of race, color, religion, sex, or national origin in Title VII) are essentially legislative exceptions to the common-law employment-at-will rule.

In the 1970s, many female employees began to claim a certain kind of sex discrimination: sexual harassment. Some women were being asked to give sexual favors in exchange for continued employment or promotion (quid pro quo sexual harassment) or found themselves in a working environment that put their chances for continued employment or promotion at risk. This form of sexual discrimination came to be called "hostile working environment" sexual harassment.

Notice that the statute itself says nothing about sexual harassment but speaks only in broad terms about discrimination "because of" sex (and four other factors). Having set the broad policy, Congress left it to employees, employers, and the courts to fashion more specific rules through the process of civil litigation.

This is a case from our federal court system, which has a trial or hearing in the federal district court, an appeal to the Sixth Circuit Court of Appeals, and a final appeal to the US Supreme Court. Teresa Harris, having lost at both the district court and the Sixth Circuit Court of Appeals, here has petitioned for a writ of certiorari (asking the court to issue an order to bring the case to the Supreme Court), a petition that is granted less than one out of every fifty times. The Supreme Court, in other words, chooses its cases carefully. Here, the court wanted to resolve a difference of opinion among the various circuit courts of appeal as to whether or not a plaintiff in a hostile-working-environment claim could recover damages without showing "severe psychological injury."

Harris v. Forklift Systems

510 U.S. 17 (U.S. Supreme Court 1992)

JUDGES: O'CONNOR, J., delivered the opinion for a unanimous Court. SCALIA, J., and GINSBURG, J., filed concurring opinions.

JUSTICE O'CONNOR delivered the opinion of the Court.

In this case we consider the definition of a discriminatorily "abusive work environment" (also known as a "hostile work environment") under Title VII of the Civil Rights Act of 1964, 78 Stat. 253, as amended, 42 U.S.C. § 2000e et seq. (1988 ed., Supp. III).

I

Teresa Harris worked as a manager at Forklift Systems, Inc., an equipment rental company, from April 1985 until October 1987. Charles Hardy was Forklift's president.

The Magistrate found that, throughout Harris' time at Forklift, Hardy often insulted her because of her gender and often made her the target of unwanted sexual innuendoes. Hardy told Harris on several occasions, in the presence of other employees, "You're a woman, what do you know" and "We need a man as the rental manager"; at least once, he told her she was "a dumbass woman." Again in front of others, he suggested that the two of them "go to the Holiday Inn to negotiate [Harris's] raise." Hardy occasionally asked Harris and other female employees to get coins from his front pants pocket. He threw objects on the ground in front of

Harris and other women, and asked them to pick the objects up. He made sexual innuendoes about Harris' and other women's clothing.

In mid-August 1987, Harris complained to Hardy about his conduct. Hardy said he was surprised that Harris was offended, claimed he was only joking, and apologized. He also promised he would stop, and based on this assurance Harris stayed on the job. But in early September, Hardy began anew: While Harris was arranging a deal with one of Forklift's customers, he asked her, again in front of other employees, "What did you do, promise the guy...some [sex] Saturday night?" On October 1, Harris collected her paycheck and quit.

Harris then sued Forklift, claiming that Hardy's conduct had created an abusive work environment for her because of her gender. The United States District Court for the Middle District of Tennessee, adopting the report and recommendation of the Magistrate, found this to be "a close case," but held that Hardy's conduct did not create an abusive environment. The court found that some of Hardy's comments "offended [Harris], and would offend the reasonable woman," but that they were not "so severe as to be expected to seriously affect [Harris's] psychological well-being. A reasonable woman manager under like circumstances would have been offended by Hardy, but his conduct would not have risen to the level of interfering with that person's work performance.

"Neither do I believe that [Harris] was subjectively so offended that she suffered injury....Although Hardy may at times have genuinely offended [Harris], I do not believe that he created a working environment so poisoned as to be intimidating or abusive to [Harris]."

In focusing on the employee's psychological well-being, the District Court was following Circuit precedent. See Rabidue v. Osceola Refining Co., 805 F.2d 611, 620 (CA6 1986), cert. denied, 481 U.S. 1041, 95 L. Ed. 2d 823, 107 S. Ct. 1983 (1987). The United States Court of Appeals for the Sixth Circuit affirmed in a brief unpublished decision...reported at 976 F.2d 733 (1992).

We granted certiorari, 507 U.S. 959 (1993), to resolve a conflict among the Circuits on whether conduct, to be actionable as "abusive work environment" harassment (no quid pro quo harassment issue is present here), must "seriously affect [an employee's] psychological well-being" or lead the plaintiff to "suffer injury." Compare Rabidue (requiring serious effect on psychological well-being); Vance v. Southern Bell Telephone & Telegraph Co., 863 F.2d 1503, 1510 (CA11 1989) (same); and Downes v. FAA, 775 F.2d 288, 292 (CA Fed. 1985) (same), with Ellison v. Brady, 924 F.2d 872, 877–878 (CA9 1991) (rejecting such a requirement).

II

Title VII of the Civil Rights Act of 1964 makes it "an unlawful employment practice for an employer...to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin." 42 U.S.C. § 2000e-2(a)(1). As we made clear in Meritor Savings Bank, FSB v. Vinson, 477 U.S. 57 (1986), this language "is not limited to 'economic' or 'tangible' discrimination. The phrase 'terms, conditions, or privileges of employment' evinces a congressional intent 'to strike at the entire spectrum of disparate treatment of men and women' in employment," which includes requiring people to work in a discriminatorily hostile or abusive environment. Id., at 64, quoting Los Angeles Dept. of Water and Power v. Manhart, 435 U.S. 702, 707, n.13, 55 L. Ed. 2d 657, 98 S. Ct. 1370 (1978). When the workplace is permeated with "discriminatory intimidation, ridicule, and insult," 477 U.S. at 65, that is "sufficiently severe or pervasive to alter the conditions of the victim's employment and create an abusive working environment," Title VII is violated.

This standard, which we reaffirm today, takes a middle path between making actionable any conduct that is merely offensive and requiring the conduct to cause a tangible psychological injury. As we pointed out in Meritor, "mere utterance of an...epithet which engenders offensive feelings in an employee," does not sufficiently affect the conditions of employment to implicate Title VII. Conduct that is not severe or pervasive enough to create an objectively hostile or abusive work environment—an environment that a reasonable person would find hostile or abusive—is beyond Title VII's purview. Likewise, if the victim does not subjectively perceive the environment to be abusive, the conduct has not actually altered the conditions of the victim's employment, and there is no Title VII violation.

But Title VII comes into play before the harassing conduct leads to a nervous breakdown. A discriminatorily abusive work environment, even one that does not seriously affect employees' psychological well-being, can and often will detract from employees' job performance, discourage employees from remaining on the job, or keep them from advancing in their careers. Moreover, even without regard to these tangible effects, the very fact that the discriminatory conduct was so severe or pervasive that it created a work environment abusive to employees because of their race, gender, religion, or national origin offends Title VII's broad rule of workplace equality. The appalling conduct alleged in Meritor, and the reference in that case to environments "'so heavily polluted with discrimination as to destroy completely the emotional and psychological stability of minority group workers,'" Id., at 66, quoting Rogers v. EEOC, 454 F.2d 234, 238 (CA5 1971), cert. denied, 406 U.S. 957,32 L. Ed. 2d 343, 92 S.

Ct. 2058 (1972), merely present some especially egregious examples of harassment. They do not mark the boundary of what is actionable.

We therefore believe the District Court erred in relying on whether the conduct "seriously affected plaintiff's psychological well-being" or led her to "suffer injury." Such an inquiry may needlessly focus the fact finder's attention on concrete psychological harm, an element Title VII does not require. Certainly Title VII bars conduct that would seriously affect a reasonable person's psychological well-being, but the statute is not limited to such conduct. So long as the environment would reasonably be perceived, and is perceived, as hostile or abusive, Meritor, supra, at 67, there is no need for it also to be psychologically injurious.

This is not, and by its nature cannot be, a mathematically precise test. We need not answer today all the potential questions it raises, nor specifically address the Equal Employment Opportunity Commission's new regulations on this subject, see 58 Fed. Reg. 51266 (1993) (proposed 29 CFR §§ 1609.1, 1609.2); see also 29 CFR § 1604.11 (1993). But we can say that whether an environment is "hostile" or "abusive" can be determined only by looking at all the circumstances. These may include the frequency of the discriminatory conduct; its severity; whether it is physically threatening or humiliating, or a mere offensive utterance; and whether it unreasonably interferes with an employee's work performance. The effect on the employee's psychological well-being is, of course, relevant to determining whether the plaintiff actually found the environment abusive. But while psychological harm, like any other relevant factor, may be taken into account, no single factor is required.

III

Forklift, while conceding that a requirement that the conduct seriously affect psychological well-being is unfounded, argues that the District Court nonetheless correctly applied the Meritor standard. We disagree. Though the District Court did conclude that the work environment was not "intimidating or abusive to [Harris]," it did so only after finding that the conduct was not "so severe as to be expected to seriously affect plaintiff's psychological well-being," and that Harris was not "subjectively so offended that she suffered injury," ibid. The District Court's application of these incorrect standards may well have influenced its ultimate conclusion, especially given that the court found this to be a "close case."

We therefore reverse the judgment of the Court of Appeals, and remand the case for further proceedings consistent with this opinion.

So ordered.

Note to Students

This was only the second time that the Supreme Court had decided a sexual harassment case. Many feminist legal studies scholars feared that the court would raise the bar and make hostile-working-environment claims under Title VII more difficult to win. That did not happen. When the question to be decided is combined with the court's decision, we get the holding of the case. Here, the question that the court poses, plus its answer, yields a holding that "An employee need not prove severe psychological injury in order to win a Title VII sexual harassment claim." This holding will be true until such time as the court revisits a similar question and answers it differently. This does happen, but happens rarely.

CASE QUESTIONS

1. Is this a criminal case or a civil-law case? How can you tell?
2. Is the court concerned with making a procedural rule here, or is the court making a statement about the substantive law?
3. Is this a case where the court is interpreting the Constitution, a federal statute, a state statute, or the common law?
4. In *Harris v. Forklift*, what if the trial judge does not personally agree that women should have any rights to equal treatment in the workplace? Why shouldn't that judge dismiss the case even before trial? Or should the judge dismiss the case after giving the female plaintiff her day in court?
5. What was the employer's argument in this case? Do you agree or disagree with it? What if those who legislated Title VII gave no thought to the question of seriousness of injury at all?

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1.7: Summary and Exercises

Summary

There are differing conceptions of what law is and of what law should be. Laws and legal systems differ worldwide. The legal system in the United States is founded on the US Constitution, which is itself inspired by natural-law theory and the idea that people have rights that cannot be taken by government but only protected by government. The various functions of the law are done well or poorly depending on which nation-state you look at. Some do very well in terms of keeping order, while others do a better job of allowing civil and political freedoms. Social and political movements within each nation greatly affect the nature and quality of the legal system within that nation.

This chapter has familiarized you with a few of the basic schools of legal thought, such as natural law, positive law, legal realism, and critical legal studies. It has also given you a brief background in common law, including contracts, torts, and criminal law. The differences between civil and criminal cases, substance and procedure, and the various sources of law have also been reviewed. Each source has a different level of authority, starting with constitutions, which are primary and will negate any lower-court laws that are not consistent with its principles and provisions. The basic differences between the common law and civil law (continental, or European) systems of law are also discussed.

EXERCISES

1. What is the common law? Where do the courts get the authority to interpret it and to change it?
2. After World War II ended in 1945, there was an international tribunal at Nuremberg that prosecuted various officials in Germany's Third Reich who had committed "crimes against humanity." Many of them claim that they were simply "following orders" of Adolf Hitler and his chief lieutenants. What law, if any, have they violated?
3. What does *stare decisis* mean, and why is it so basic to common-law legal tradition?
4. In the following situations, which source of law takes priority, and why?
    1. The state statute conflicts with the common law of that state.
    2. A federal statute conflicts with the US Constitution.
    3. A common-law decision in one state conflicts with the US Constitution.
    4. A federal statute conflicts with a state constitution.

SELF-TEST QUESTIONS

1. The source of law that is foundational in the US legal system is
    1. the common law
    2. statutory law
    3. constitutional law
    4. administrative law
2. "Law is the command of a sovereign" represents what school of legal thought?
    1. civil law
    2. constitutional law
    3. natural law
    4. ecofeminist law
    5. positive law
3. Which of the following kinds of law are most often found in state law rather than federal law?
    1. torts and contracts
    2. bankruptcy
    3. maritime law
    4. international law
4. Where was natural law discovered?
    1. in nature
    2. in constitutions and statutes
    3. in the exercise of human reason

4. in the *Wall Street Journal*

5. Wolfe is a state court judge in California. In the case of *Riddick v. Clouse*, which involves a contract dispute, Wolfe must follow precedent. She establishes a logical relationship between the Riddick case and a case decided by the California Supreme Court, *Zhu v. Patel Enterprises, Inc.* She compares the facts of Riddick to the facts in Zhu and to the extent the facts are similar, applies the same rule to reach her decision. This is
    1. deductive reasoning
    2. faulty reasoning
    3. linear reasoning
    4. reasoning by analogy
6. Moore is a state court judge in Colorado. In the case of *Cassidy v. Seawell*, also a contract dispute, there is no Colorado Supreme Court or court of appeals decision that sets forth a rule that could be applied. However, the California case of *Zhu v. Patel Enterprises, Inc.* is "very close" on the facts and sets forth a rule of law that could be applied to the Cassidy case. What process must Moore follow in considering whether to use the Zhu case as precedent?
    1. Moore is free to decide the case any way he wants, but he may not look at decisions and reasons in similar cases from other states.
    2. Moore must wait for the Colorado legislature and the governor to pass a law that addresses the issues raised in the Cassidy case.
    3. Moore must follow the California case if that is the best precedent.
    4. Moore may follow the California case if he believes that it offers the best reasoning for a similar case.

SELF-TEST AnswerS

1. c
2. e
3. a
4. c
5. d
6. d

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2: CORPORATE SOCIAL RESPONSIBILITY AND BUSINESS ETHICS

Learning Objectives

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

1. Define ethics and explain the importance of good ethics for business people and business organizations.
2. Understand the principal philosophies of ethics, including utilitarianism, duty-based ethics, and virtue ethics.
3. Distinguish between the ethical merits of various choices by using an ethical decision model.
4. Explain the difference between shareholder and stakeholder models of ethical corporate governance.
5. Explain why it is difficult to establish and maintain an ethical corporate culture in a business organization.

A great society is a society in which [leaders] of business think greatly about their functions. -Alfred North Whitehead

Few subjects are more contentious or important as the role of business in society, particularly, whether corporations have social responsibilities that are distinct from maximizing shareholder value. While the phrase “business ethics” is not oxymoronic (i.e., a contradiction in terms), there is plenty of evidence that businesspeople and firms seek to look out primarily for themselves. However, business organizations ignore the ethical and social expectations of consumers, employees, the media, nongovernment organizations (NGOs), government officials, and socially responsible investors at their peril. Legal compliance alone no longer serves the long-term interests of many companies, who find that sustainable profitability requires thinking about people and the planet as well as profits.

This chapter has a fairly modest aim: to introduce potential businesspeople to the differences between legal compliance and ethical excellence by reviewing some of the philosophical perspectives that apply to business, businesspeople, and the role of business organizations in society.

2.1: What Is Ethics?

2.2: Major Ethical Perspectives

2.3: An Ethical Decision Model

2.4: Corporations and Corporate Governance

2.5: Summary and Exercises

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2.1: What Is Ethics?

LEARNING OBJECTIVES

1. Explain how both individuals and institutions can be viewed as ethical or unethical.
2. Explain how law and ethics are different, and why a good reputation can be more important than legal compliance.

What Is Ethics?

Most writers use the terms **ethics** and **morality** interchangeably, although some suggest subtle differences. *Morality* is sometimes described as personal values, while *ethics* refers to broader social standards or the application of moral reasoning in particular contexts (e.g., business ethics, medical ethics, journalistic ethics). For our purposes, the two terms mean the same thing: the study of what is right, just, or good in human conduct.

We regularly speak of the morality of individuals and of the ethics of corporations or nations. While people may be seen as having conscience or soul, organizations and governments are not thought of in the same way. Yet society still judges their conduct morally—calling some nations "corrupt" or labeling companies such as Enron or WorldCom "unethical." These judgments show that ethical standards extend beyond individual behavior to collective action.

A word like *good* can be confusing, because it carries both ethical and nonethical meanings. If someone says that Microsoft is a "good company," they may mean it is profitable, influential, or technologically advanced. Only when "good" refers to qualities like honesty, fairness, or responsibility does it reflect moral or ethical assessment. Likewise, calling a person a "good guy" could describe charm, humor, or athletic ability—qualities that do not necessarily reflect moral character. By contrast, words like *honest*, *caring*, or *forthright* point directly to ethical traits.

Three important observations can be made about ethics:

1. While not precisely measurable, people generally agree on which behaviors are ethical or unethical.
2. As human beings, we need and value ethical conduct in those around us.
3. Being law-abiding is not the same as being ethical.

Recognizing ethical issues, applying sound decision-making, and acting with moral courage can be difficult, especially in organizational settings where employees face competing motivations and loyalties. Building an ethical culture where values are clear, respected, and consistently practiced is one of the greatest challenges for modern institutions.

How Do Law and Ethics Differ?

The law sets **minimum standards of conduct**, but ethics asks for more. Perfect legal compliance is not the same as moral excellence. A physician, lawyer, or accountant who follows every statute to the letter may still fall short of providing excellent, ethical service.

Business ethicists emphasize that what is **legal is not always ethical**, and what is **ethical is not always legal**. For example, "legal loopholes" may allow companies to avoid taxes without breaking the law, yet such behavior is often criticized as unethical.

Two ideas help explain the business case for ethics:

- **Reputation matters.** Individuals and organizations are judged by how others perceive their honesty, fairness, and reliability. Reputation creates **goodwill**, which is an intangible asset but one that directly affects customer loyalty, employee morale, and investor confidence.
- **Goodwill has real value.** In the sale of a business, goodwill is often included as part of the purchase price. Conversely, legal problems or ethical scandals reduce a company's valuation and can even drive stock prices down when negative news becomes public.

Laws themselves often reflect society's moral judgments. Fraud statutes express the belief that cheating is wrong; laws against assisted suicide reflect collective views on life and death. Understanding law therefore requires understanding the ethical perspectives that inform public policy debates—whether about stem-cell research, marijuana use, or abortion. These debates are less about facts and more about **clashing moral values**.

Why Should an Individual or Business Be Ethical?

The standard answer is that **good ethics is good business**. In the long run, ethical conduct tends to foster trust, customer loyalty, and sustainable success. Measuring this effect is difficult, since "the long run" is vague and ethics lacks universally accepted metrics. Still, history shows that unethical conduct damages markets and destroys reputations.

- **Royal Dutch/Shell** faced boycotts and investor backlash for its environmental and human-rights practices, forcing the company to rethink its focus on short-term profit.
- **Sears Auto Centers** lost lasting consumer trust after revelations of unfair practices, with customers vowing never to return.
- **Arthur Andersen**, once a respected accounting firm, collapsed after its role in the Enron scandal—even though its criminal conviction was later overturned. Andersen's original motto, "Think straight, talk straight," underscored how far it had strayed from its founding values.

Maximizing profits within the law is not an inspiring vision. Businesses and professionals need higher standards—values of integrity, responsibility, and fairness that motivate people to excel and sustain stakeholder trust.

Key Takeaway

Legal compliance is not the same as ethical conduct. Reputation and goodwill—though difficult to measure—are real assets that depend on ethical behavior. For individuals and organizations alike, acting ethically safeguards trust, strengthens long-term success, and provides a higher standard of excellence than the law alone can demand.

EXERCISES

1. Think of a person who did something morally wrong, at least to your way of thinking. What was it? Explain to a friend of yours—or a classmate—why you think it was wrong. Does your friend agree? Why or why not? What is the basic principle that forms the basis for your judgment that it was wrong?
2. Think of a person who did something morally right, at least to your way of thinking. (This is not a matter of finding something they did well, like efficiently changing a tire, but something good.) What was it? Explain to a friend of yours—or a classmate—why you think it was right. Does your friend agree? Why or why not? What is the basic principle that forms the basis for your judgment that it was right?
3. Think of an action by a business organization (sole proprietor, partnership, or corporation) that was legal but still strikes you as wrong. What was it? Why do you think it was wrong?
4. Think of an act by an individual or a corporation that is ethical but not legal. Compare your answer with those of your classmates: were you more likely to find an example from individual action or corporate action? Do you have any thoughts as to why?

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2.2: Major Ethical Perspectives

LEARNING OBJECTIVES

1. Describe the various major theories about ethics in human decision making.
2. Begin considering how the major theories about ethics apply to difficult choices in life and business.

Perspectives on Ethical Decision-Making

There are several well-established ways to analyze ethical questions. Some scholars champion a single "best" approach; others recommend viewing problems through multiple lenses. This section surveys four influential perspectives: **(1) utilitarianism, (2) deontology (duty-based ethics), (3) social justice and social contract theory, and (4) virtue ethics**. (Important additional perspectives—such as rights-based theories and feminist ethics—are beyond our present scope.)

Utilitarianism

Core idea. Utilitarianism focuses on outcomes, not rules: an action is right if it **maximizes overall happiness or utility**. Associated with **Jeremy Bentham** and **John Stuart Mill**, utilitarianism can guide both public policy and private decision-making.

Two forms.

- **Act utilitarianism:** Of the options available now, which *action* yields the greatest net good for society?
- **Rule utilitarianism:** Which *general rule*, if consistently followed, would produce the greatest net good?

Where it shows up. Cost-benefit analysis, environmental impact assessments, marketing and product comparisons, tax policy, strategic planning, and many regulatory decisions reflect utilitarian reasoning.

Common pitfalls.

- **Too few options.** Choosing among one or two familiar paths instead of generating broader alternatives.
- **Self-interest bias.** Equating "best for me/us" with "best overall."
- **Mispriced risks.** Undervaluing harms to others (e.g., historical cases where companies underestimated safety costs).
- **Short-termism.** Favoring immediate gains over larger long-term costs.
- **Monetizing everything.** Treating health, safety, or dignity as if they were fully reducible to dollars.

Deontology (Duty-Based Ethics)

Core idea. In contrast to results-first thinking, deontology (most notably **Immanuel Kant**) holds that ethical action arises from **duty**, guided by principles we can **universalize** and that **respect persons as ends in themselves**.

Two tests.

- **Reversibility:** Would this action be acceptable if I were on the receiving end?
- **Consistency (universalizability):** Could everyone act this way without undermining the very practice (e.g., lying cannot be universalized because it collapses trust)?

Strengths and limits. Deontology powerfully protects honesty, promise-keeping, and respect for persons. It can feel rigid in gray areas (e.g., breaking a promise to save a life; permitting small harms to secure vital goods like employment).

Social Justice and Social Contract Theory

Core idea. These perspectives ask what constitutes **fair distribution** of benefits and burdens and what **mutual agreements** rational people would adopt to live together.

- **Social contract (Hobbes → modern theorists).** People trade some freedoms for order and security; communities (from nations to universities) establish norms members can accept—or exit.
- **Justice debates.** Competing views range from need-based redistribution to minimal-state capitalism; many systems blend welfare provisions with market freedoms.
- **Rights and duties.** Rights (free speech, due process) imply duties (government restraint, fair procedures) and exist both **against the state** and **between individuals**.

Useful distinctions.

- **Basic vs. nonbasic rights** (e.g., subsistence vs. luxuries).
- **Positive vs. negative rights** (to education/healthcare vs. to be free from coercion).
- **Economic/social vs. political/civil rights.**

Communitarian note. Rights are tethered to responsibilities; communities thrive when members honor both.

Virtue Ethics

Core idea. Tracing to **Aristotle**, virtue ethics emphasizes **character**: the cultivated habits (virtues) that enable people to live excellently—honesty, courage, temperance, generosity, fairness, and more.

- **Happiness as excellence.** For Aristotle, flourishing (eudaimonia) is the **active, rational pursuit of excellence**, not wealth, pleasure, or fame.
- **Modern application.** Organizations also express "character" through culture and values. Firms that prize only short-term profit risk eroding trust; those that define and practice core values build durable reputations.

Contemporary core values (Josephson Institute).
Trustworthiness, Respect, Responsibility, Fairness, Caring, Citizenship.
These are distinctly ethical traits (unlike wealth or wit). Reputations—individual and corporate—are fragile; one serious lapse can overshadow years of good conduct.

Key Takeaway

Ethical theories illuminate different facets of "doing what's right." **Utilitarianism** prioritizes outcomes and overall welfare; **deontology** centers on duties and universal principles; **social justice/contract** theories stress fair terms of cooperation, rights, and responsibilities; and **virtue ethics** focuses on the moral character needed to live—and lead—well. Considering multiple lenses often yields better, more balanced decisions.

EXERCISES

XYZ Motor Corporation begins to get customer complaints about two models of its automobiles. Customers have had near-death experiences from sudden acceleration; they would be driving along a highway at normal speed when suddenly the car would begin to accelerate, and efforts to stop the acceleration by braking fail to work. Drivers could turn off the ignition and come to a safe stop, but XYZ does not instruct buyers of its cars to do so, nor is this a common reaction among drivers who experience sudden acceleration.

Internal investigations of half a dozen accidents in US locations come to the conclusion that the accidents are not being caused by drivers who mistake the gas pedal for the brake pedal. In fact, there appears to be a possible flaw in both models, perhaps in a semiconductor chip, that makes sudden acceleration happen. Interference by floor mats and poorly designed gas pedals do not seem to be the problem.

It is voluntary to report these incidents to the National Highway Traffic and Safety Administration (NHTSA), but the company decides that it will wait awhile and see if there are more complaints. Recalling the two models so that local dealers and their mechanics could examine them is also an option, but it would be extremely costly. Company executives are aware that quarterly and annual profit-and-loss statements, on which their bonuses depend, could be decisively worse with a recall. They decide that on a cost-benefit basis, it makes more sense to wait until there are more accidents and more data. After a hundred or more accidents and nearly fifteen fatalities, the company institutes a selective recall, still not notifying NHTSA, which has its own experts and the authority to order XYZ to do a full recall of all affected models.

Experts have advised XYZ that standard failure-analysis methodology requires that the company obtain absolutely every XYZ vehicle that has experienced sudden acceleration, using microscopic analysis of all critical components of the electronic system. The company does not wish to take that advice, as it would be—as one top executive put it—"too time-consuming and expensive."

1. Can XYZ's approach to this problem be justified under utilitarian theory? If so, how? If not, why not?
2. What would Kant advise XYZ to do? Explain.
3. What would the "virtuous" approach be for XYZ in this situation?

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2.3: An Ethical Decision Model

LEARNING OBJECTIVE

1. Understand one model for ethical decision making: a process to arrive at the most ethical option for an individual or a business organization, using a virtue ethics approach combined with some elements of stakeholder analysis and utilitarianism.

Josephson's Core Values Model

Purpose. Once you spot that a decision has an ethical dimension, Josephson's model gives you a clear, practical way to reason it through.

The decision process

1. **Identify stakeholders.** Who stands to gain or lose under plausible choices?
2. **List reasonable options.** Don't stop at the first two—generate several.
3. **Map impacts.** For each option, note who benefits, who is burdened, and how.
4. **Test against core values.** Which option best honors **trustworthiness, respect, responsibility, fairness, caring,** and **citizenship**?
5. **If needed, use a tie-breaker.** When no option clearly satisfies the most core values, choose the one that produces the **greatest net good** for stakeholders.

> **Who "matters most"?** Views differ. Milton Friedman emphasized shareholder primacy; John Mackey (Whole Foods) argues that long-term success can require prioritizing customers or other stakeholders in certain moments.

The core values (with working cues)

- **Trustworthiness**
  Be honest and transparent; don't deceive, cheat, or steal; keep confidences appropriately; **integrity** (walk your talk); **loyalty** without violating core principles; **keep promises** and repay debts.

- **Respect**
  Judge on merits, not appearances; be courteous and open to differences; honor others' autonomy; don't demean, exploit, or mistreat.

- **Responsibility**
  Accountability (own consequences); be reliable and do your duties; credit others' work; **pursue excellence** (diligence, perseverance); **self-restraint**—know the difference between what you *can* do and what is *right* to do.

- **Fairness**
  Be consistent and impartial; listen to opposing views; use relevant criteria; don't take unfair advantage or more than your share.

- **Caring**
  Show kindness, empathy, and compassion; treat others as you'd want to be treated; avoid selfish or cruel conduct.

- **Citizenship**
  Follow the rules and the law; do your share, stay informed, vote; help the community; protect the environment and conserve resources.

Practical notes

- In most situations, step **4** yields a clear answer; step **5** is a fallback.
- Even with a solid analysis, **pressures and constraints** (time, incentives, hierarchy) can derail ethical choices—especially when doing the right thing **costs money** in the short term or when "everyone else" may not follow suit. Build routines (checklists, pre-commitments, escalation paths) to make the ethical choice the easy choice.

KEY TAKEAWAY

A step-by-step framework anchored in the six core values—trustworthiness, respect, responsibility, fairness, caring, and citizenship—sharpens ethical awareness and usually points to the most defensible decision; when values are evenly balanced, choose the option that delivers the greatest overall good for stakeholders.

EXERCISE

1. Consider XYZ in the exercises for Section 2.2.5 "Josephson's Core Values Analysis and Decision Process" and use the core values decision-making model. What are XYZ's options when they first notice that two of their models are causing sudden acceleration incidents that put their customers at risk? Who are the stakeholders? What options most clearly meet the criteria for each of the core values?

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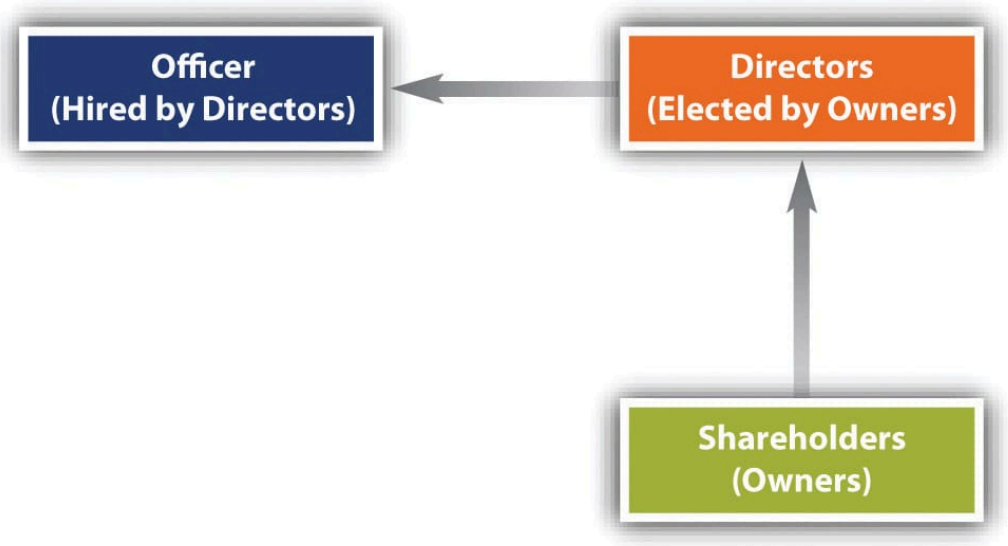
2.4: Corporations and Corporate Governance

LEARNING OBJECTIVES

1. Explain the basic structure of the typical corporation and how the shareholders own the company and elect directors to run it.
2. Understand how the shareholder profit-maximization model is different from stakeholder theory.
3. Discern and describe the ethical challenges for corporate cultures.
4. Explain what conscious capitalism is and how it differs from stakeholder theory.

Legal Organization of the Corporation

Figure 2.1 Corporate Legal Structure



Corporate Legal Structure

Figure 2.1 ("Corporate Legal Structure"), though simplified, illustrates the basic governance model of a corporation under Delaware law and most U.S. state laws. **Shareholders elect directors**, who in turn **hire officers** (the C-suite) to run day-to-day operations.

This separation creates what's known as the **agency problem**: managers may act in their own interest rather than in the shareholders' best interest. For example:

- A **CEO** might engage in insider trading that benefits themselves but harms shareholders.
- **Board members** may resist takeover bids to preserve their perks, even if shareholders would profit.

Efforts like **stock options** were designed to align managers' interests with shareholders, but these sometimes incentivized "managing by numbers"—inflating short-term results rather than building sustainable value. While shareholders ultimately retain power to replace directors, in practice oversight can be weak unless reinforced by law, regulation, or activist pressure.

Shareholders vs. Stakeholders

There are two competing views of corporate duties:

1. **Shareholder Primacy (Friedman's View).**
   The corporation's sole moral duty is to maximize profits for its shareholders, within the rules of law and fair competition. Managers have a **fiduciary duty**—a legal and moral responsibility to act as responsible agents of shareholders' money.

   > Milton Friedman (1970) argued: "There is one and only one social responsibility of business: to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game."

   In this view, spending corporate money on social causes without shareholder approval is misusing other people's money.

2. **Stakeholder Theory.**
   This approach broadens responsibility to **employees, suppliers, customers, creditors, and communities**. The rationale: corporations exist only because the state grants charters and **limited liability**, which allow shareholders to risk only their investment. In return, corporations are expected to be **socially useful**.

   A socially responsible company weighs the impacts of its actions on multiple stakeholders. For example:

   - **Shareholders** seek returns.
   - **Employees** want fair pay and job security.
   - **Communities** expect safety, jobs, and responsible environmental practices.
   - **Suppliers/creditors** rely on fair dealing and timely payments.

   Table 2.1 ("The Stakes of Various Stakeholders") summarizes these categories:

   - **Ownership stakes**: managers, directors, shareholders.
   - **Economic dependence**: employees, suppliers, local communities.
   - **Social interests**: government, media, society at large.

Table 2.1 The Stakes of Various Stakeholders

The Stakes of Various Stakeholders

Ownership	The value of the organization has a direct impact on the wealth of these stakeholders.	Managers
		Directors who own stock
		Shareholders
Economic Dependence	Stakeholders can be economically dependent without having ownership. Each of these stakeholders relies on the corporation in some way for financial well-being.	Salaried managers
		Creditors
		Suppliers
		Employees
		Local communities
Social Interests	These stakeholders are not directly linked to the organization but have an interest in making sure the organization acts in a socially responsible manner.	Communities
		Government
		Media

Corporate Culture and Codes of Ethics

A corporation is a **legal person** with rights and duties. Its **culture**—values and behaviors modeled internally—often shapes ethical

conduct more than formal rules.

Key observations:

- **Ethical leadership is top-down.** Employees take cues from what leaders *do*, not what they *say*.
- **Accountability is often weak.** Managers may deflect blame or "game the numbers."
- **Whistleblowers risk retaliation.** Examples include Enron executives who tried to warn leadership.
- **Ethics codes matter only if lived.** Johnson & Johnson's Tylenol crisis response is celebrated because its code was active and authentic. By contrast, Enron's "3-P code" (Print, Post, Pray) was suspended when convenient.
- **Federal sentencing guidelines** (since 1991) encourage companies to maintain ethics programs, hotlines, and compliance officers by reducing penalties if misconduct occurs despite these safeguards.

Case in Point: Sears Auto Center

In the early 1990s, **Sears Auto Centers** faced lawsuits for systematically overcharging and recommending unnecessary repairs. The company settled for over $30 million and suffered a **15–20% drop in sales**, plus long-lasting reputational damage.

Lessons:

- Short-term profit schemes can inflict long-term losses.
- Consumers' lack of technical knowledge created a **market failure**, which Sears exploited.
- Employees fell into an "us vs. them" mindset, treating customers as outsiders to be used rather than valued.

Conscious Capitalism

A modern approach that blends profit with purpose is **conscious capitalism**. Leaders like John Mackey (Whole Foods) argue corporations should seek **win-win outcomes** for all stakeholders.

Key features:

- **Higher purpose** beyond profit.
- **Servant leadership**—leaders act as stewards for stakeholders.
- **Holistic thinking**—recognizing interdependence among customers, employees, investors, and communities.

Rather than relying on laws to curb abuse, conscious capitalism emphasizes building a **culture of trust, purpose, and responsibility** where profits and positive social impact reinforce one another.

Key Take Away

The legal structure of corporations creates tensions between shareholders, managers, and broader society. Milton Friedman emphasized shareholder primacy, while stakeholder theorists stress broader duties. In practice, corporate culture, ethical leadership, and approaches like conscious capitalism can determine whether a company achieves only short-term profits or builds sustainable value rooted in trust, fairness, and social responsibility.

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2.5: Summary and Exercises

Summary

Doing good business requires attention to ethics as well as law. Understanding the long-standing perspectives on ethics—utilitarianism, deontology, social contract, and virtue ethics—is helpful in sorting out the ethical issues that face us as individuals and businesses. Each business needs to create or maintain a culture of ethical excellence, where there is ongoing dialogue not only about the best technical practices but also about the company's ethical challenges and practices. A firm that has purpose and passion beyond profitability is best poised to meet the needs of diverse stakeholders and can best position itself for long-term, sustainable success for shareholders and other stakeholders as well.

EXERCISES

1. Consider again Milton Friedman's article.
    1. What does Friedman mean by "ethical custom"?
    2. If the laws of the society are limiting the company's profitability, would the company be within its rights to disobey the law?
    3. What if the law is "on the books," but the company could count on a lack of enforcement from state officials who were overworked and underpaid? Should the company limit its profits? Suppose that it could save money by discharging a pollutant into a nearby river, adversely affecting fish and, potentially, drinking water supplies for downstream municipalities. In polluting against laws that aren't enforced, is it still acting "within the rules of the game"? What if almost all other companies in the industry were saving money by doing similar acts?
2. Consider again the *Harris v. Forklift* case at the end of Chapter 1 "Introduction to Law and Legal Systems". The Supreme Court ruled that Ms. Harris was entitled to be heard again by the federal district court, which means that there would be a trial on her claim that Mr. Hardy, owner of Forklift Systems, had created a "hostile working environment" for Ms. Harris. Apart from the legal aspects, did he really do anything unethical? How can you tell?
    1. Which of his actions, if any, were contrary to utilitarian thinking?
    2. If Kant were his second-in-command and advising him on ethical matters, would he have approved of Mr. Hardy's behavior? Why or why not?
3. Consider the behaviors alleged by Ms. Harris and assume for a moment that they are all true. In terms of core values, which of these behaviors are not consistent with the core values Josephson points to? Be specific.
4. Assume that Forklift Systems is a large public corporation and that the CEO engages in these kinds of behaviors. Assume also that the board of directors knows about it. What action should the board take, and why?
5. Assume that the year is 1963, prior to the passage of the Civil Rights Act of 1964 and the Title VII provisions regarding equal employment opportunity that prohibit discrimination based on sex. So, Mr. Hardy's actions are not illegal, fraudulent, or deceitful. Assume also that he heads a large public company and that there is a large amount of turnover and unhappiness among the women who work for the company. No one can sue him for being sexist or lecherous, but are his actions consistent with maximizing shareholder returns? Should the board be concerned?

    Notice that this question is really a stand-in for any situation faced by a company today regarding its CEO where the actions are not illegal but are ethically questionable. What would conscious capitalism tell a CEO or a board to do where some group of its employees are regularly harassed or disadvantaged by top management?

SELF-TEST QUESTIONS

1. Milton Friedman would have been most likely to agree to which of the following statements?
    1. The purpose of the corporation is to find a path to sustainable corporate profits by paying careful attention to key stakeholders.
    2. The business of business is business.
    3. The CEO and the board should have a single-minded focus on delivering maximum value to shareholders of the business.
    4. All is fair in love, war, and business.
2. Milton Friedman meant (using the material quoted in this chapter) that companies should
    1. Find a path to sustainable profits by looking at the interconnected needs and desires of all the stakeholders.

2. Always remember that the business of business is business.
3. Remind the CEO that he or she has one duty: to maximize shareholder wealth by any means possible.
4. Maximize shareholder wealth by engaging in open competition without fraud or deceit.

3. What are some key drawbacks to utilitarian thinking at the corporate level?
    1. The corporation may do a cost-benefit analysis that puts the greatest good of the firm above all other considerations.
    2. It is difficult to predict future consequences; decision makers in for-profit organizations will tend to overestimate the upside of certain decisions and underestimate the downside.
    3. Short-term interests will be favored over long-term consequences.
    4. all of the above
    5. a and b only
4. Which ethical perspective would allow that under certain circumstances, it might be ethical to lie to a liar?
    1. deontology
    2. virtue ethics
    3. utilitarianism
    4. all of the above
5. Under conscious capitalism,
    1. Virtue ethics is ignored.
    2. Shareholders, whether they be traders or long-term investors, are always the first and last consideration for the CEO and the board.
    3. Maximizing profits comes from a focus on higher purposes and harmonizing the interests of various stakeholders.
    4. Kantian duties take precedence over cost-benefit analyses.

SELF-TEST AnswerS

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

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3: COURTS AND THE LEGAL PROCESS

Learning Objectives

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

1. Describe the two different court systems in the United States, and explain why some cases can be filed in either court system.
2. Explain the importance of subject matter jurisdiction and personal jurisdiction and know the difference between the two.
3. Describe the various stages of a civil action: from pleadings, to discovery, to trial, and to appeals.
4. 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.

3.1: Cases

3.2: Courts and the Legal Process

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

3.4: The Problem of Jurisdiction

3.5: Motions and Discovery

3.6: The Pretrial and Trial Phase

3.7: Judgment, Appeal, and Execution

3.8: When Can Someone Bring a Lawsuit?

3.9: Relations with Lawyers

3.10: Alternative Means of Resolving Disputes

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3.1: 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." 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 "Introduction to Tort Law", 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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3.2: Courts and the Legal Process

Introduction to Courts and the Legal Process

When a dispute arises, one of the first questions to ask is: *which court should hear the case, and which law will apply?* Consider the story of Harry and Kay Robinson. In 1976, the Robinsons purchased a new Audi from a dealership in New York. A year later, while driving through Oklahoma on their way to a new home in Arizona, their car was struck from behind. The Audi's gas tank ruptured, causing a fire that severely injured Kay Robinson and the couple's two children.

The Robinsons filed a products-liability lawsuit in Oklahoma state court, alleging that a defect in the Audi's fuel system caused their injuries. They named as defendants not only the German manufacturer, Audi, but also Volkswagen of America (the importer), World-Wide Volkswagen Corp. (the regional distributor in New York), and Seaway Volkswagen (the retail dealer where they had purchased the car).

This case raises fundamental questions about the U.S. legal system: Should the Robinsons file in state or federal court? Does an Oklahoma court have the authority to hear a case involving out-of-state and even international defendants? And if the case moves forward, which body of law will govern—New York law, Oklahoma law, federal law, or German law?

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

LEARNING OBJECTIVES

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

Courts and the Legal Process

Although people often speak of "two court systems"—state and federal—the reality is more complex. The United States actually has fifty-two court systems: one for each of the fifty states, one for the District of Columbia, and the federal court system. While these systems are distinct, they frequently overlap and interact.

For example, state and local courts must honor federal law under the **Supremacy Clause** of the U.S. Constitution. When state and federal law conflict, federal law prevails. Likewise, under the **Full Faith and Credit Clause**, states must recognize and enforce the final judgments of courts from other states. This prevents a party from relitigating the same case simply by crossing state lines. State courts may also be required to apply the laws of another state when disputes involve people or events connected to more than one state.

At the same time, federal courts often deal with state law. For instance, when a lawsuit involves both state and federal claims, a federal court can hear the entire case under a doctrine called **pendent jurisdiction**. The U.S. Supreme Court also reviews cases from state supreme courts when they raise significant issues of federal law—for example, whether a state's method of execution violates the Eighth Amendment's ban on cruel and unusual punishment.

Another major category of federal cases involves disputes between citizens of different states, known as **diversity jurisdiction**. The framers of the Constitution feared that state courts might favor their own residents over outsiders, so they allowed federal courts to hear these disputes. Diversity jurisdiction still matters today. Defense attorneys often prefer federal court, believing it reduces any "home-court advantage" an in-state plaintiff might enjoy. Federal courts also tend to move cases along faster, apply uniform procedures, and sometimes award higher judgments.

State Court Systems

Most civil lawsuits in the United States are filed in state courts. State systems vary, but they generally include three levels:

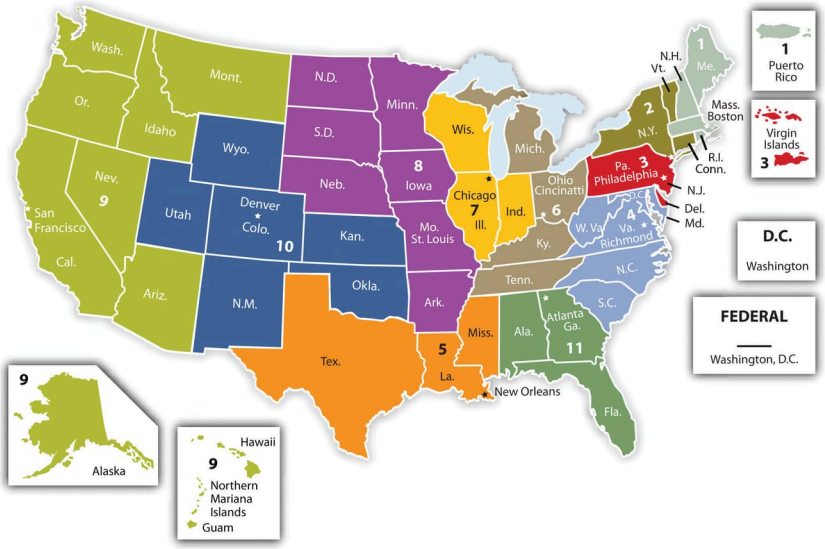
1. **Limited jurisdiction courts** – Handle minor criminal offenses (traffic violations, petty assaults) and small civil disputes, usually with dollar limits (often under $10,000). **Small claims courts**, a familiar example, resolve disputes quickly and informally, often without lawyers.
2. **General jurisdiction courts** – Known by names such as *superior*, *district*, *circuit*, or *common pleas* courts, these handle serious criminal cases (murder, robbery, rape) and major civil disputes (contract breaches, personal injury, family law). Juries often serve as fact-finders here.
3. **Appellate courts** – Intermediate appellate courts (in forty states) review trial court decisions to ensure the law was applied correctly. Above them, the **state supreme court** serves as the final arbiter of state law. In most cases, its rulings are final—though the U.S. Supreme Court may step in when federal issues are at stake.

The Federal Court System

The federal courts also operate in three tiers:

1. **U.S. District Courts** – The trial courts of the federal system. Every state has at least one district; larger states like California, New York, and Texas have several. Federal district courts handle both civil and criminal cases.
2. **U.S. Courts of Appeal** – Thirteen circuit courts hear appeals from the district courts. For example, the Ninth Circuit covers much of the western United States, including California, Arizona, and Washington. Panels of three judges typically hear appeals, though some cases are reheard *en banc* by all circuit judges.
3. **The U.S. Supreme Court** – At the top sits the nation's highest court. With nine justices, the Court has selective control over its docket. Each year, thousands of petitions are filed, but only a small percentage are granted review. The Court's decisions not only resolve individual disputes but also set binding precedent for all courts in the United States.

Figure 3.1 The Federal Judicial Circuits



Federal Judges

Federal judges—including U.S. Supreme Court justices—are nominated by the president and must be confirmed by the Senate. Once confirmed, they serve for life under the Constitution's provision of "good behavior," meaning they remain in office until they retire, resign, pass away, or are removed through impeachment. This lifetime appointment is designed to insulate judges from political pressures and allow them to make decisions based on law rather than popular opinion or fear of losing reelection.

This system contrasts with most state courts, where judges are typically elected by voters or appointed for fixed terms of years. State judges therefore face political accountability at regular intervals, while federal judges have independence but also the heavy responsibility of exercising impartial judgment.

Because of their life tenure, federal judges often influence the law long after the presidents who appointed them have left office. For example, Supreme Court justices appointed in the 1980s continue to shape constitutional law today, underscoring the long-term impact of judicial appointments.

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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3.4: The Problem of Jurisdiction

LEARNING OBJECTIVES

1. Explain the concept of subject matter jurisdiction and distinguish it from personal jurisdiction.
2. Understand how and where the US Constitution provides a set of instructions as to what federal courts are empowered by law to do.
3. Know which kinds of cases must be heard in federal courts only.
4. Explain diversity of citizenship jurisdiction and be able to decide whether a case is eligible for diversity jurisdiction in the federal courts.
5. Explain how pleadings, including the complaint and the answer, serve to initiate a lawsuit and define the issues in dispute between the parties.

Jurisdiction: The Power to Speak the Law

Jurisdiction is a foundational concept in understanding courts and the legal system. The word itself comes from two Latin roots: *juris* (law) and *diction* (to speak). Put simply, jurisdiction answers this question: **Which court has the authority "to speak the law" in a particular case?**

Before a judge will hear any case, two questions of jurisdiction must be resolved:

1. **Subject matter jurisdiction** – Does this court have the power to hear this type of case?
2. **Personal jurisdiction** – Does this court have authority over the parties involved?

Courts always begin with subject matter jurisdiction. If a court lacks power to hear the kind of case presented, it must dismiss it—even if the underlying claim has merit.

Federalism and the Division of Power

The U.S. legal system operates under **federalism**, a structure in which power is divided between the federal government and the states. This arrangement created two court systems—state and federal—that coexist and often intersect.

Article III of the U.S. Constitution establishes that federal courts are courts of **limited jurisdiction**. They may only hear cases with a strong federal connection, such as:

- Cases arising under federal law (a "federal question").
- Admiralty and maritime cases.
- Cases involving the United States as a party.
- Disputes between states or between citizens of different states.

By contrast, state courts handle the vast majority of legal matters, particularly those traditionally reserved to the states: contracts, torts, property, family law, and probate. For example, you wouldn't go to federal court to obtain a marriage license, file for divorce, or probate a will—those matters remain within the jurisdiction of state courts.

Exclusive Federal Jurisdiction

While state courts have broad authority, some matters can **only** be heard in federal courts. These include:

- Disputes between states.
- Cases involving ambassadors or foreign ministers.
- Federal crimes (e.g., treason, piracy, counterfeiting).

- Bankruptcy proceedings.
- Patent, copyright, and trademark cases.
- Admiralty and maritime disputes.
- Antitrust matters.
- Securities and banking regulation.
- Any other cases that Congress has designated as federal-only.

If a case falls into one of these categories, a state court has no authority to hear it.

Concurrent Jurisdiction

Many legal disputes fall into a gray area where **either state or federal courts may hear the case**. This is known as **concurrent jurisdiction** and arises most commonly in two situations:

1. **Federal Question Jurisdiction** – The plaintiff's claim is based on federal law (e.g., employment discrimination under Title VII).
2. **Diversity Jurisdiction** – The plaintiff and defendant are from different states *and* the amount in controversy exceeds $75,000.

In diversity cases, federal courts apply **federal procedural law** but **state substantive law**. For instance, if a New York plaintiff sues a Texas defendant over a contract dispute worth $200,000, the case may be brought in federal court. The federal judge will use federal rules of procedure but apply the relevant state's contract law to decide the case.

Strategic Choices: State vs. Federal Court

Whether a case ends up in state or federal court often depends on legal strategy:

- Plaintiffs may prefer federal court for efficiency, speed, or potentially higher verdicts.
- Defendants often prefer federal court because federal judges are appointed (not elected), juries are drawn from a wider geographic area, and the forum may be perceived as more neutral.

Defendants can also request **removal**—moving a case from state to federal court—if the requirements for federal jurisdiction are met.

Example: Wile E. Coyote v. Acme, Inc.

Suppose Wile E. Coyote sues Acme, Inc. for injuries caused by a defective product:

- **Scenario 1**: Wile lives in Arizona. Acme is incorporated in Delaware and headquartered in Illinois. Because the parties are from different states and the amount in controversy exceeds $75,000, Wile can bring the case in federal court. The judge will apply federal procedural rules but use Arizona's product liability law.
- **Scenario 2**: Wile lives in Arizona. Acme is incorporated in Delaware but headquartered in Phoenix, Arizona. In this case, complete diversity does not exist—both parties have ties to Arizona. Unless Wile's claim is based on a federal law, the case must stay in Arizona state court.

Key Points on Subject Matter Jurisdiction

- A court must have **both subject matter jurisdiction and personal jurisdiction** to hear a case.
- **State courts** have broad authority and can hear almost any case unless federal law makes jurisdiction exclusive to federal courts.
- **Federal courts** have limited jurisdiction, hearing cases only when a federal question is involved or when diversity requirements are met.

- Filing in the wrong court can waste time and, if the statute of limitations expires, may bar the case altogether.

Determining Jurisdiction

State Court Jurisdiction

Step 1: Residency

- **Q1:** Does the defendant reside in the state where the lawsuit is filed?
  - *Individuals*: Permanent residence in the state.
  - *Corporations*: Incorporated in the state.
  - **Yes** → The court has **in personam jurisdiction**. (Stop here.)
  - **No** → Go to Step 2.

Step 2: Long-Arm Statute

- **Q2:** Does the state have a long-arm statute?
  - **Yes** → Move to Step 3.
  - (All 50 states and D.C. have long-arm statutes, but they differ.)
    - *Enumerated statutes* list specific grounds (e.g., committing a tort, doing business, owning property in the state).
    - *Broad statutes* (e.g., California) extend jurisdiction as far as the U.S. Constitution allows under the **minimum contacts** test.

Step 3: Minimum Contacts

- **Q3:** Does the defendant have sufficient "minimum contacts" with the state? (International Shoe v. Washington)
  - **Individual Defendants:**
    - Did the defendant purposefully avail themselves of the state (e.g., conduct business, travel, or activities there)?
    - Did the lawsuit arise from those activities?
    - Is there a substantial connection between the defendant's activities and the state?
  - **Corporate Defendants:**
    - Does the corporation regularly do business in the state?
    - OR did the corporation place goods into the "stream of commerce" intending sales in that state?

If the answer is **Yes** → The court has personal jurisdiction, consistent with due process.
If the answer is **No** → The court lacks jurisdiction.

Federal Court Jurisdiction

Step 1: Federal Question

- **Q1:** Does the case involve a federal question (U.S. Constitution, federal statute, or treaty)?
  - **Yes** → Federal district court has jurisdiction. (Stop here.)
  - **No** → Move to Step 2.

Step 2: Diversity of Citizenship

- **Q2:** Is there **complete diversity** of citizenship *and* an amount in controversy over $75,000?

- *Complete diversity*: No plaintiff may reside in the same state as any defendant.
- *Amount in controversy*: Plaintiff's good-faith claim must exceed $75,000.
- **Yes** → Federal court has jurisdiction.
- **No** → Case must be heard in state court.

Robinson v. Audi: A Case Study in Jurisdiction

Consider the products-liability lawsuit brought by Harry and Kay Robinson after their Audi automobile was struck from behind while they were traveling through Oklahoma. The collision caused a fire that severely injured Kay Robinson and the couple's children. The Robinsons filed suit in an Oklahoma state court against four defendants:

- **Seaway Volkswagen, Inc.**, the New York retailer that sold them the car,
- **World-Wide Volkswagen Corp.**, the regional distributor,
- **Volkswagen of America, Inc.**, the importer, and
- **Audi NSU Auto Union Aktiengesellschaft**, the German manufacturer.

At first glance, several jurisdictional questions arise:

1. **Does the Oklahoma state court have subject matter jurisdiction?**
   - Since there is no federal products-liability statute, the Robinsons are suing under state common-law negligence or strict liability principles.
   - State courts have broad subject matter jurisdiction unless a case falls into a category of exclusive federal jurisdiction (such as bankruptcy or patents). Therefore, Oklahoma's general jurisdiction trial courts could hear this case.
   - However, the Robinsons must file in the appropriate level of court—small claims or probate courts would not be suitable because of the nature and size of the claim.
2. **Could the Robinsons file in federal court?**
   - There is no **federal question**, and the United States is not a party, so the only possible basis would be **diversity of citizenship**.
   - If the Robinsons had established Arizona residency by the time of filing, diversity might exist—provided none of the defendants was incorporated in or had its principal place of business in Arizona.
   - In federal court, the judge would apply federal procedural law but state substantive law. The key conflict-of-law question would be whether to apply **Oklahoma law** (the place of the accident) or **New York law** (the place of sale).

This case illustrates the complexity of jurisdictional analysis. Even when plaintiffs choose the correct court system (state vs. federal), they must still ensure that the particular court has subject matter jurisdiction—and, in federal court, that diversity requirements are fully satisfied.

Table 3.1 Sample Conflict-of-Law Principles

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

To understand how courts resolve disputes, it is important to look at the basic steps of litigation and the rules that ensure fairness.

Courts must have both **subject matter jurisdiction** and **personal jurisdiction** over at least one defendant before a lawsuit can proceed.

Although courts are central to dispute resolution, they are not the only forum. Later (Section 3.9), we will examine **alternative methods** such as arbitration and mediation. For now, we focus on how courts handle civil disputes.

The Adversary System

In the United States, litigation operates under the **adversary system**, where opposing parties present their best arguments, evidence, and legal reasoning. Lawyers act as advocates, shaping facts and arguments to persuade the court of their client's position. Judges (and sometimes juries) then evaluate the proofs and arguments to reach a decision.

Adjudication has several important features:

- **Focus on relevant issues.** Judges limit consideration to questions raised in the case.
- **Reasoned decisions.** Judges must explain their rulings in written opinions (unless the case is decided by a jury verdict).
- **Obligation to decide.** Courts cannot ignore disputes brought before them.
- **Public and rule-based process.** Courts follow established procedural rules and burdens of proof—*preponderance of the evidence* in civil cases, and *beyond a reasonable doubt* in criminal cases.

The principle of **res judicata** ("the thing is decided") means that once a case is finally resolved, the same dispute cannot be brought again between the same parties.

How a Case Begins

A civil lawsuit starts when the **plaintiff files a complaint**, which is the first type of **pleading**. A pleading is any formal written statement of a party's claims or defenses. The complaint lays out the legal grounds for the lawsuit. The court then issues a **summons**, which must be served on the defendant to provide notice of the lawsuit.

Service of process can be accomplished in several ways:

- Personal delivery of the summons and complaint,
- Delivery at the defendant's residence to a competent person,
- Certified mail with proof of receipt, or
- Publication in a newspaper (when the defendant cannot be located).

Timing is critical: most claims are governed by a **statute of limitations**, which sets strict deadlines for filing.

The Defendant's Answer

Once the plaintiff files the complaint (a pleading that begins the lawsuit), the defendant is required to respond by filing another pleading called an **Answer**. The Answer is the defendant's formal written response to the allegations set out in the complaint.

In the Answer, the defendant must:

- **Admit or deny each allegation** made by the plaintiff.
- Raise any **defenses** that explain why the defendant should not be held liable.
- Include any **affirmative defenses**—legal reasons that, even if the plaintiff's claims are true, provide a complete defense to liability (e.g., statute of limitations has expired, self-defense, assumption of risk).
- Assert any **counterclaims** against the plaintiff, if the defendant believes the plaintiff has also caused harm.

If the defendant fails to file an Answer within the time allowed by law (usually 20 or 30 days, depending on the jurisdiction), the court may enter a **default judgment** in favor of the plaintiff. A default judgment means the plaintiff automatically wins because

the defendant did not respond.

Together, the plaintiff's complaint and the defendant's answer are called the **pleadings**. These documents establish the issues in dispute and frame the boundaries of the lawsuit.

Jurisdiction and Venue

Two location-based questions must be answered:

1. **Subject matter jurisdiction.** Courts must have the legal authority to hear the type of case (e.g., contract, tort, copyright).
2. **Venue.** Even within the right court system, the lawsuit must be filed in the proper geographic location (usually where the defendant resides or where the dispute arose).

Personal Jurisdiction and Due Process

Even if a court has subject matter jurisdiction, it must also be fair—under the **due process clause of the Fourteenth Amendment**—to require a defendant to appear. This is known as **personal jurisdiction**.

- A court always has personal jurisdiction over defendants served within its state.
- For out-of-state defendants, personal jurisdiction depends on "**minimum contacts**" with the state, so that requiring them to defend a lawsuit there does not offend "traditional notions of fair play and substantial justice" (Burger King v. Rudzewicz).
- Most states have **long-arm statutes** that extend jurisdiction to nonresidents when fairness permits.

Bases for personal jurisdiction include:

- **Consent** (the defendant answers without objecting),
- **Domicile** (the defendant lives in the state),
- **Events** (the defendant's actions in the state give rise to the lawsuit), and
- **Service within the state** (if the defendant is served while present there).

Choice of Law and Forum Clauses

Contracts often include clauses that determine:

- **Which law will apply** if a dispute arises (choice-of-law clause), and
- **Where disputes must be litigated** (choice-of-forum clause).

Courts typically enforce these clauses unless they were agreed to under fraud or bad faith.

Example: Robinson v. Audi

Returning to the Robinsons' case: they could file a products-liability claim in Oklahoma state court, which has subject matter jurisdiction. But personal jurisdiction over each defendant becomes more complicated. The court must decide whether it is fair to require out-of-state corporations—like the New York retailer or the German manufacturer—to defend the case in Oklahoma. This analysis shows how due process and long-arm statutes limit the reach of state courts over nonresident defendants.

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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3.5: Motions and Discovery

LEARNING OBJECTIVES

1. Explain how a lawsuit can be dismissed prior to any trial.
2. 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

A civil action begins with the **pleadings**—the plaintiff's *complaint* (a pleading that lays out the claim and requested relief) and the defendant's *answer* (a pleading that admits, denies, or raises defenses to the allegations). Sometimes the defendant will also file a *counterclaim*, and the plaintiff may reply. (See the earlier section on pleadings for more detail.)

Once the pleadings are filed, the parties may make **motions**—formal requests to the judge. Early motions often ask the court to dismiss the lawsuit, change the venue, or require the other party to act in certain ways. For example:

- A **motion to dismiss** may argue that the court lacks subject matter jurisdiction or personal jurisdiction, or that the complaint fails to state a claim on which relief can be granted.
- A **motion for summary judgment** may be filed later, asking the court to rule without a trial because there are no genuine disputes of fact and the moving party is entitled to judgment as a matter of law.

If the lawsuit is not dismissed, the case proceeds to **discovery**, the process by which both sides gather and exchange information before trial. Discovery is often the most time-consuming and expensive part of litigation, but it is also crucial because it ensures fairness and reduces "trial by surprise."

Discovery

If there is a factual dispute, the case will usually involve some degree of **discovery**, the process by which each side gathers evidence from the other before trial. Discovery is designed to prevent trial by surprise, promote fairness, and encourage settlement by making the strengths and weaknesses of each case more apparent.

Under modern rules of civil procedure (both federal and most states), discovery is very broad. Each party is entitled to information that is **relevant** to the claims or defenses and that may reasonably lead to admissible evidence—even if it would not itself be admissible at trial. This means discovery often goes far beyond what a jury will ever see.

Main Discovery Tools

1. **Interrogatories** – Written questions one party sends to the other, which must be answered in writing and under oath. For example, in a car accident case, one party may send interrogatories asking the other to identify all eyewitnesses, provide medical treatment details, or disclose insurance coverage.
2. **Depositions** – Oral questioning of a party or witness, taken under oath and recorded by a court reporter (sometimes also video-recorded). Depositions allow attorneys to probe testimony, evaluate credibility, and preserve statements for later use at trial. For example, a deposition of a corporate executive may take several days and be crucial to shaping the case strategy.
3. **Requests for Production of Documents and Things** – A party may demand to inspect and copy relevant documents, records, or other physical evidence. In business disputes, this often includes emails, contracts, accounting records, or even

entire databases. In product liability cases, it may include product prototypes, safety-testing records, or engineering reports.
4. **Requests for Admission** – One party asks the other to admit or deny specific facts in writing. This streamlines the trial by narrowing what must actually be proven in court.
5. **Physical or Mental Examinations** – In cases involving personal injury or claims of emotional distress, a party may request that the other undergo a medical or psychological evaluation by a qualified professional.

Discovery Disputes

Because discovery can be burdensome and invasive, disputes are common. Parties may seek a **protective order** if they believe requests are overly broad, irrelevant, privileged (e.g., attorney-client communications), or designed to harass. Conversely, if a party refuses to provide information, the requesting party can file a **motion to compel discovery**, asking the judge to order compliance. Courts can also impose sanctions—including fines or even dismissal of claims—for failure to cooperate in good faith.

Practical Realities of Discovery

- **Scope and cost**: In large commercial cases, discovery can take years, with millions of pages of documents and dozens of depositions. Discovery is often the most expensive and time-consuming phase of litigation.
- **Technology**: Today, discovery frequently involves **electronic discovery (e-discovery)**—emails, texts, metadata, and digital records. Specialized software and experts are often needed to search, retrieve, and analyze vast amounts of electronic data.
- **Settlement leverage**: Because discovery reveals the evidence, many cases settle once both sides understand the risks of going to trial. A damaging email uncovered in discovery, for example, may lead a defendant to settle rather than face a jury.
- **Judicial role**: Judges generally leave discovery to the lawyers but intervene when necessary to enforce rules, protect parties from abuse, and maintain fairness.

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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3.6: The Pretrial and Trial Phase

LEARNING OBJECTIVES

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

Pretrial Motions, Conferences, and Trial

Motions for Summary Judgment

After discovery, one party may believe there are no genuine disputes of law or fact for a jury to consider and may file a **motion for summary judgment**. If granted, this motion ends the case at the trial level—it is a *final order* and triggers the principle of **res judicata** (the matter cannot be relitigated). Because summary judgment cuts off the right to trial, judges are cautious and will usually deny the motion unless the absence of a factual dispute is clear. If a summary judgment is granted, the losing party may appeal; if reversed, the case is sent back to the trial court.

Pretrial Conferences and Settlement

Judges often encourage settlement before trial. At a **pretrial conference**, the judge meets with the attorneys to clarify issues, establish a trial timetable, and explore settlement possibilities. Settlement conferences may also be held separately to see if the parties can avoid the risks and costs of trial. This process is significant, as most lawsuits never make it to trial—approximately **85% of civil cases** settle and over **90% of criminal prosecutions** end with guilty pleas.

Trial

Jury Selection

If a jury trial is requested (a right in most civil cases under the Seventh Amendment and guaranteed in criminal cases under the Sixth), the first stage of trial is **voir dire**—the questioning of potential jurors to ensure impartiality. Both attorneys may challenge jurors:

- **For cause** challenges are based on specific bias or conflict.
- **Peremptory challenges** allow dismissal without explanation, though they may not be used for discriminatory purposes (per *Batson v. Kentucky*).

Juries typically include 6 to 12 members, plus alternates.

Presentation of Evidence

1. **Opening Statements**: The plaintiff outlines the case, followed by the defendant’s opening or a reserved statement.
2. **Plaintiff’s Case**: Witnesses and evidence are presented under direct examination.
3. **Cross-Examination**: Defense counsel challenges credibility and reliability.
4. **Redirect / Re-Cross**: Limited follow-up questioning.
5. **Defendant’s Case**: Presented in the same format.
6. **Rebuttal and Surrebuttal**: Additional testimony to counter the opposing side.

The trial is governed by the **rules of evidence**, ensuring relevance and fairness.

Directed Verdicts

At the close of evidence, either party may move for a **directed verdict** (also called a judgment as a matter of law). This asks the judge to rule without jury input because one side has failed to meet its burden of proof. Directed verdicts are rarely granted, since deciding disputed facts is generally the jury's role.

Closing Arguments and Jury Instructions

After evidence is presented, both sides make **closing arguments**, weaving together the facts and urging a favorable verdict. The judge then delivers **jury instructions**, explaining the applicable law and outlining the factual determinations the jury must make. Many states use standardized "pattern jury instructions" to reduce the risk of reversible error.

Verdict

The jury deliberates privately until it reaches a verdict, usually requiring unanimity in criminal cases and often in civil cases. If the jury cannot agree, it results in a **hung jury**, and the case may be retried. If no jury is present, the judge issues findings of fact and conclusions of law.

Posttrial Motions

The losing party may file posttrial motions, including:

- **Motion for a new trial**: arguing that errors or misconduct affected the outcome.
- **Judgment notwithstanding the verdict (judgment n.o.v.)**: asking the judge to set aside the jury's verdict and enter judgment in favor of the moving party.

Under **Rule 50(b) of the Federal Rules of Civil Procedure**, judges may grant judgment n.o.v. if the jury's verdict lacks legal support. States have similar rules. Judges often prefer this approach over granting a directed verdict mid-trial, as it preserves the jury's role and provides a fallback if the decision is reversed on appeal.

Key Takeaway

The trial judge's central role is to ensure a fair trial for all parties. While harmless errors are inevitable, only **prejudicial errors**—those that compromise fairness—justify overturning a verdict on appeal. Judges must balance deference to the jury with their duty to prevent unjust outcomes, carefully exercising discretion on motions for summary judgment, directed verdicts, and judgment n.o.v.

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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3.7: Judgment, Appeal, and Execution

LEARNING OBJECTIVES

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

Judgment, Orders, and Appeals

Judgment or Order

At the end of a trial, the judge issues an **order** that contains findings of fact (often based on the jury's determinations) and conclusions of law. The order includes the **judgment**—the court's final decision about what relief or remedy should be granted. This may involve awarding money damages, issuing an injunction, or declaring the rights of the parties. The losing party may file posttrial motions, such as a request for a new trial or a judgment notwithstanding the verdict. Once those motions are denied (or the time to file them has passed), the judgment becomes **final** at the trial court level.

Appeal

If dissatisfied, the losing party may **appeal**. To do so, the appellant usually must post a bond to secure payment of the judgment in case the appeal fails. An appeal does not involve a new trial—the appellate court reviews the record from the trial court to determine whether **prejudicial errors** were made. Harmless mistakes are not enough; only errors that compromise fairness will justify reversal.

On appeal:

- The parties submit **briefs**, written arguments that summarize the facts, legal issues, and supporting authorities.
- In many cases, the court will also hold **oral arguments**, where attorneys present their positions and respond to judges' questions.
- The appellate court may affirm, modify, reverse, or remand (send the case back to the lower court for further proceedings).

Precedent and Authority

Appellate decisions create **precedent**, which lower courts must follow. But precedent is limited:

- **Holdings**—the core legal rule necessary to decide the case—are binding.
- **Dicta**—statements not essential to the decision—are persuasive but not binding.

The binding force of precedent also depends on hierarchy:

- State trial courts must follow decisions of their state's appellate and supreme courts.
- Federal district courts are bound by the U.S. Court of Appeals in their circuit.
- All courts must follow the U.S. Supreme Court on federal issues.

Enforcement of Judgments

When no further appeals are possible, the losing party must comply. If payment is not made voluntarily, the winning party may enforce the judgment through:

- **Seizure of assets**,
- **Wage garnishment**, or
- **Contempt proceedings** if the judgment requires specific action (e.g., following an injunction).

KEY TAKEAWAY

The conclusion of a trial does not always mean the end of a case. Posttrial motions and appeals allow parties to challenge errors, but appellate courts focus only on law, not new evidence. Ultimately, the system of pleadings, motions, discovery, trial, judgment, and appeals is designed to provide **fairness and finality**: each party has an opportunity to be heard, procedural protections are preserved, and once all appeals are exhausted, the judgment carries the force of law.

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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3.8: When Can Someone Bring a Lawsuit?

LEARNING OBJECTIVES

1. Explain the requirements for standing to bring a lawsuit in US courts.
2. 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.

EXERCISE

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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3.9: Relations with Lawyers

LEARNING OBJECTIVES

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

Legal Fees and Costs

Hiring a lawyer can be one of the most significant expenses in pursuing or defending a lawsuit. Because litigation often requires extensive time, research, and preparation, it is important to understand how attorneys are paid. Lawyers in the United States typically charge clients in one of three ways: a flat fee for routine services, an hourly rate for ongoing work, or a contingent fee that depends on winning the case. Each arrangement has advantages and drawbacks for clients, and each is better suited for different types of legal matters. In addition to attorneys' fees, there are also litigation costs to consider, and the U.S. follows the "American Rule," where each party generally pays its own costs, unless specific exceptions apply.

Types of Legal Fees

1. **Flat Rate**
   - **Definition:** A single, predetermined fee for a specific task.
   - **Example:** A lawyer charges $1,000 to draft a will or $2,500 to handle the closing of a house sale. The fee is set in advance regardless of how much time the task takes.
   - **Note:** Sometimes calculated as a percentage (e.g., 1% of the sale price of a home).
2. **Hourly Rate**
   - **Definition:** The client pays for the actual time the lawyer spends working on the case.
   - **Example:** In a contract dispute, an associate lawyer charges $300 per hour for research and drafting, while a senior partner charges $500 per hour for trial strategy and courtroom arguments. A case that takes 50 hours of lawyer time could cost between $15,000 and $25,000.
3. **Contingent Fee**
   - **Definition:** The lawyer is paid only if the case is won, usually receiving a percentage of the recovery.
   - **Example:** In a car accident case, the client hires a lawyer on a 33% contingency fee. If the client wins $90,000 in damages, the lawyer receives $30,000 as payment. If the case is lost, the client owes nothing for the lawyer's time (though may still owe court filing or expert witness fees).

Litigation Costs and the "American Rule"

Legal disputes involve more than just lawyers' fees. Filing fees, deposition transcripts, and expert witnesses can all add up.

- **American Rule:** Each party pays its own legal fees, regardless of who wins.
  - *Example:* If a plaintiff sues for breach of contract and loses, she must still pay her own lawyer's fees.
- **British Rule:** The losing party pays both sides' legal fees.
  - *Example:* If the same plaintiff brought the case in England and lost, she would be responsible not only for her lawyer's fees but also for the defendant's fees.

Exceptions to the American Rule

1. **Statutory Exceptions**
   - **Example:** A plaintiff wins a civil rights lawsuit under Title VII. Federal law allows recovery of attorneys' fees, so the defendant may be ordered to pay both the damages and the plaintiff's legal fees.

2. **Bad Faith Litigation**
    - **Example:** A corporation files a frivolous lawsuit to intimidate a competitor. The judge dismisses the case and orders the corporation to pay the competitor's reasonable attorney's fees because the lawsuit was brought in bad faith.

KEY TAKEAWAY

Litigation is costly. Clients must carefully consider fee arrangements and the potential risks of paying legal expenses. While contingent fees make justice more accessible for some, the American rule generally means **each side bears its own legal costs**, unlike many other countries where the loser pays both sides' fees.

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 Chamberlain. 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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3.10: Alternative Means of Resolving Disputes

LEARNING OBJECTIVES

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

Alternative Dispute Resolution (ADR)

The traditional path for resolving legal disputes is through litigation in the courts. While litigation provides formal procedures and enforceable judgments, it is also time-consuming, costly, and adversarial. To address these challenges, **Alternative Dispute Resolution (ADR)** has become a popular set of methods for resolving disputes outside of court. ADR can save parties money and time, reduce the emotional toll of conflict, and provide more flexible solutions tailored to the needs of the parties involved. The three most common ADR methods are **negotiation, mediation, and arbitration**.

Negotiation

Negotiation is the simplest and most informal method of resolving disputes. In negotiation, the parties communicate directly with each other, with or without attorneys, to reach a mutually acceptable solution. No third party is involved, and the outcome depends entirely on the willingness of the parties to compromise.

- **Example**: Two business partners in a contract dispute may sit down to renegotiate the terms rather than file a lawsuit. If both sides want to preserve the relationship, negotiation allows them to maintain control and flexibility.

Negotiation is often the first step in any dispute, and many conflicts are resolved at this stage without moving on to more formal ADR processes.

Mediation

Mediation involves the use of a neutral third party, called a **mediator**, to help disputing parties reach an agreement. Unlike an arbitrator, the mediator does not make binding decisions. Instead, the mediator facilitates communication, identifies issues, and suggests possible solutions.

- **Example**: In a workplace conflict, a mediator may help an employee and employer discuss grievances and find a resolution, such as adjusting work responsibilities or providing additional training.

Mediation is particularly effective when parties want to preserve a long-term relationship—such as in family disputes, business partnerships, or community disagreements—because it encourages cooperation rather than confrontation. The parties retain full control over whether to accept or reject the mediator's proposals.

Arbitration

Arbitration is more formal than negotiation or mediation but less formal than court litigation. In arbitration, the parties submit their dispute to a neutral decision maker—the **arbitrator**—who hears evidence and arguments and issues a **binding decision** known as an arbitral award.

Key features of arbitration include:

- **Binding outcome**: The arbitrator's decision is final and enforceable in court.

- **Flexibility**: Procedures are simpler than court trials, but parties may agree on rules in advance.
- **Expertise**: Parties can select arbitrators with specialized knowledge in law, business, or technical fields.
- **Example**: A construction company and a property owner may agree to arbitrate disputes over delays or costs before a retired judge with experience in construction law.

Two main advantages of arbitration are **speed and efficiency** (arbitrators typically have lighter caseloads than courts) and the ability to select arbitrators with subject matter expertise.

Arbitration Clauses

Arbitration often enters the picture through **arbitration clauses** in contracts. These clauses require parties to resolve disputes through arbitration rather than litigation. Arbitration clauses are common in commercial contracts, consumer agreements, and employment contracts.

- **Example**: A credit card agreement may include a clause stating that disputes over billing must be arbitrated instead of taken to court.

Courts generally enforce arbitration clauses under the **Federal Arbitration Act (FAA)**, unless the clause is found to be unconscionable or grossly unfair.

Arbitration in Employment Contracts

Many employers require employees to sign arbitration agreements as a condition of employment. These agreements typically state that disputes over wages, discrimination, or wrongful termination must be resolved through arbitration rather than through court litigation.

Supporters argue that arbitration is faster and less expensive than litigation and prevents court dockets from becoming overloaded. Critics, however, contend that mandatory arbitration can disadvantage employees by limiting their ability to have their “day in court,” especially in cases involving discrimination or harassment.

Providers of ADR Services

Several organizations provide structured ADR services, offering rules, procedures, and trained neutrals:

- **American Arbitration Association (AAA)**: The most prominent ADR provider in the United States, offering arbitration and mediation services in commercial, consumer, labor, and international disputes.
- **JAMS (Judicial Arbitration and Mediation Services)**: A private provider of ADR services, often used in high-value commercial disputes.
- **National Futures Association (NFA)** and **Financial Industry Regulatory Authority (FINRA)**: Specialize in disputes in securities, commodities, and investment industries.
- **International Chamber of Commerce (ICC)**: Provides international commercial arbitration, particularly for cross-border business disputes.

These providers ensure consistency and fairness in ADR by setting out detailed rules and supplying experienced arbitrators and mediators.

KEY TAKEAWAY

ADR offers alternatives to costly and time-consuming litigation. **Negotiation** allows parties to control the outcome directly, **mediation** facilitates compromise through a neutral third party without binding authority, and **arbitration** provides a final, binding decision that is enforceable in court. Arbitration clauses—especially in consumer and employment contracts—have become common, and organizations such as the **AAA** and **JAMS** play a central role in administering these processes.

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 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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4: CONSTITUTIONAL LAW AND US COMMERCE

Learning Objectives

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

1. Explain the historical importance and basic structure of the US Constitution.
2. Know what judicial review is and what it represents in terms of the separation of powers between the executive, legislative, and judicial branches of government.
3. Locate the source of congressional power to regulate the economy under the Constitution, and explain what limitations there are to the reach of congressional power over interstate commerce.
4. Describe the different phases of congressional power over commerce, as adjudged by the US Supreme Court over time.
5. Explain what power the states retain over commerce, and how the Supreme Court may sometimes limit that power.
6. Describe how the Supreme Court, under the supremacy clause of the Constitution, balances state and federal laws that may be wholly or partly in conflict.
7. Explain how the Bill of Rights relates to business activities in the United States.

The US Constitution is the foundation for all of US law. Business and commerce are directly affected by the words, meanings, and interpretations of the Constitution. Because it speaks in general terms, its provisions raise all kinds of issues for scholars, lawyers, judges, politicians, and commentators. For example, arguments still rage over the nature and meaning of "federalism," the concept that there is shared governance between the states and the federal government. The US Supreme Court is the ultimate arbiter of those disputes, and as such it has a unique role in the legal system. It has assumed the power of **judicial review**, unique among federal systems globally, through which it can strike down federal or state statutes that it believes violate the Constitution and can even void the president's executive orders if they are contrary to the Constitution's language. No knowledgeable citizen or businessperson can afford to be ignorant of its basic provisions.

4.1: Basic Aspects of the US Constitution

4.2: The Commerce Clause

4.3: Dormant Commerce Clause

4.4: Preemption- The Supremacy Clause

4.5: Business and the Bill of Rights

4.6: Cases

4.7: Summary and Exercises

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4.1: Basic Aspects of the US Constitution

LEARNING OBJECTIVES

1. Describe the American values that are reflected in the US Constitution.
2. Know what federalism means, along with separation of powers.
3. Explain the process of amending the Constitution and why judicial review is particularly significant.

The Constitution as Reflecting American Values

In the US, the one document to which all public officials and military personnel pledge their unswerving allegiance is the Constitution. If you serve, you are asked to "support and defend" the Constitution "against all enemies, foreign and domestic." The oath usually includes a statement that you swear that this oath is taken freely, honestly, and without "any purpose of evasion." This loyalty oath may be related to a time—fifty years ago—when "un-American" activities were under investigation in Congress and the press; the fear of communism (as antithetical to American values and principles) was paramount. As you look at the Constitution and how it affects the legal environment of business, please consider what basic values it may impart to us and what makes it uniquely American and worth defending "against all enemies, foreign and domestic."

In Article I, the Constitution places the legislature first and prescribes the ways in which representatives are elected to public office. Article I balances influence in the federal legislature between large states and small states by creating a Senate in which the smaller states (by population) as well as the larger states have two votes. In Article II, the Constitution sets forth the powers and responsibilities of the branch—the presidency—and makes it clear that the president should be the commander in chief of the armed forces. Article II also gives states rather than individuals (through the Electoral College) a clear role in the election process. Article III creates the federal judiciary, and the Bill of Rights, adopted in 1791, makes clear that individual rights must be preserved against activities of the federal government. In general, the idea of rights is particularly strong.

The Constitution itself speaks of rights in fairly general terms, and the judicial interpretation of various rights has been in flux. The "right" of a person to own another person was notably affirmed by the Supreme Court in the *Dred Scott* decision in 1857.In *Scott v. Sanford* (the Dred Scott decision), the court states that Scott should remain a slave, that as a slave he is not a citizen of the United States and thus not eligible to bring suit in a federal court, and that as a slave he is personal property and thus has never been free. The "right" of a child to freely contract for long, tedious hours of work was upheld by the court in *Hammer v. Dagenhart* in 1918. Both decisions were later repudiated, just as the decision that a woman has a "right" to an abortion in the first trimester of pregnancy could later be repudiated if *Roe v. Wade* is overturned by the Supreme Court.*Roe v. Wade*, 410 US 113 (1973).

General Structure of the Constitution

Look at the Constitution. Notice that there are seven articles, starting with Article I (legislative powers), Article II (executive branch), and Article III (judiciary). Notice that there is no separate article for administrative agencies. The Constitution also declares that it is "the supreme Law of the Land" (Article VI). Following Article VII are the ten amendments adopted in 1791 that are referred to as the Bill of Rights. Notice also that in 1868, a new amendment, the Fourteenth, was adopted, requiring states to provide "due process" and "equal protection of the laws" to citizens of the United States.

Federalism

The partnership created in the Constitution between the states and the federal government is called **federalism**. The Constitution is a document created by the states in which certain powers are delegated to the national government, and other powers are reserved to the states. This is made explicit in the Tenth Amendment.

Separation of Powers and Judicial Review

Because the Founding Fathers wanted to ensure that no single branch of the government, especially the executive branch, would be ascendant over the others, they created various checks and balances to ensure that each of the three principal branches had

ways to limit or modify the power of the others. This is known as the **separation of powers**. Thus the president retains veto power, but the House of Representatives is entrusted with the power to initiate spending bills.

Power sharing was evident in the basic design of Congress, the federal legislative branch. The basic power imbalance was between the large states (with greater population) and the smaller ones (such as Delaware). The smaller ones feared a loss of sovereignty if they could be outvoted by the larger ones, so the federal legislature was constructed to guarantee two Senate seats for every state, no matter how small. The Senate was also given great responsibility in ratifying treaties and judicial nominations. The net effect of this today is that senators from a very small number of states can block treaties and other important legislation. The power of small states is also magnified by the Senate's cloture rule, which currently requires sixty out of one hundred senators to vote to bring a bill to the floor for an up-or-down vote.

Because the Constitution often speaks in general terms (with broad phrases such as "due process" and "equal protection"), reasonable people have disagreed as to how those terms apply in specific cases. The United States is unique among industrialized democracies in having a Supreme Court that reserves for itself that exclusive power to interpret what the Constitution means. The famous case of *Marbury v. Madison* began that tradition in 1803, when the Supreme Court had marginal importance in the new republic. The decision in *Bush v. Gore*, decided in December of 2000, illustrates the power of the court to shape our destiny as a nation. In that case, the court overturned a ruling by the Florida Supreme Court regarding the way to proceed on a recount of the Florida vote for the presidency. The court's ruling was purportedly based on the "equal protection of the laws" provision in the Fourteenth Amendment.

From *Marbury* to the present day, the Supreme Court has articulated the view that the US Constitution sets the framework for all other US laws, whether statutory or judicially created. Thus any statute (or portion thereof) or legal ruling (judicial or administrative) in conflict with the Constitution is not enforceable. And as the *Bush v. Gore* decision indicates, the states are not entirely free to do what they might choose; their own sovereignty is limited by their union with the other states in a federal sovereign.

If the Supreme Court makes a "bad decision" as to what the Constitution means, it is not easily overturned. Either the court must change its mind (which it seldom does) or two-thirds of Congress and three-fourths of the states must make an amendment (Article V).

Because the Supreme Court has this power of judicial review, there have been many arguments about how it should be exercised and what kind of "philosophy" a Supreme Court justice should have. President Richard Nixon often said that a Supreme Court justice should "strictly construe" the Constitution and not add to its language. Finding law in the Constitution was "judicial activism" rather than "judicial restraint." The general philosophy behind the call for "strict constructionist" justices is that legislatures make laws in accord with the wishes of the majority, and so unelected judges should not make law according to their own views and values. Nixon had in mind the 1960s Warren court, which "found" rights in the Constitution that were not specifically mentioned—the right of privacy, for example. In later years, critics of the Rehnquist court would charge that it "found" rights that were not specifically mentioned, such as the right of states to be free from federal antidiscrimination laws. See, for example, *Kimel v. Florida Board of Regents*, or the *Citizens United v. Federal Election Commission* case (Section 4.6.5), which held that corporations are "persons" with "free speech rights" that include spending unlimited amounts of money in campaign donations and political advocacy.*Kimel v. Florida Board of Regents*, 528 US 62 (2000).

Because *Roe v. Wade* has been so controversial, this chapter includes a seminal case on "the right of privacy," *Griswold v. Connecticut*, Section 4.6.1. Was the court was correct in recognizing a "right of privacy" in Griswold? This may not seem like a "business case," but consider: the manufacture and distribution of birth control devices is a highly profitable (and legal) business in every US state. Moreover, Griswold illustrates another important and much-debated concept in US constitutional law: substantive due process (see Section 4.5.3 "Fifth Amendment"). The problem of judicial review and its proper scope is brought into sharp focus in the abortion controversy. Abortion became a lucrative service business after *Roe v. Wade* was decided in 1973. That has gradually changed, with state laws that have limited rather than overruled *Roe v. Wade* and with persistent antiabortion protests, killings of abortion doctors, and efforts to publicize the human nature of the fetuses being aborted. The key here is to understand that there is no *explicit* mention in the Constitution of any right of privacy. As Justice Harry Blackmun argued in his majority opinion in *Roe v. Wade*,

The Constitution does not explicitly mention any right of privacy. In a line of decisions, however, the Court has recognized that a right of personal privacy or a guarantee of certain areas or zones of privacy, does exist under the Constitution....[T]hey also make it clear that the right has some extension to activities relating to marriage...procreation...contraception...family relationships...and child rearing and education....The right of privacy...is broad enough to encompass a woman's decision whether or not to terminate her pregnancy.

In short, justices interpreting the Constitution wield quiet yet enormous power through judicial review. In deciding that the right of privacy applied to a woman's decision to abort in the first trimester, the Supreme Court did not act on the basis of a popular mandate or clear and unequivocal language in the Constitution, and it made illegal any state or federal legislative or executive action contrary to its interpretation. Only a constitutional amendment or the court's repudiation of *Roe v. Wade* as a precedent could change that interpretation.

KEY TAKEAWAY

The Constitution gives voice to the idea that people have basic rights and that a civilian president is also the commander in chief of the armed forces. It gives instructions as to how the various branches of government must share power and also tries to balance power between the states and the federal government. It does not expressly allow for judicial review, but the Supreme Court's ability to declare what laws are (or are not) constitutional has given the judicial branch a kind of power not seen in other industrialized democracies.

EXERCISES

1. Suppose the Supreme Court declares that Congress and the president cannot authorize the indefinite detention of terrorist suspects without a trial of some sort, whether military or civilian. Suppose also that the people of the United States favor such indefinite detention and that Congress wants to pass a law rebuking the court's decision. What kind of law would have to be passed, by what institutions, and by what voting percentages?
2. When does a prior decision of the Supreme Court deserve overturning? Name one decision of the Supreme Court that you think is no longer "good law." Does the court have to wait one hundred years to overturn its prior case precedents?

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4.2: The Commerce Clause

LEARNING OBJECTIVES

1. Name the specific clause through which Congress has the power to regulate commerce. What, specifically, does this clause say?
2. Explain how early decisions of the Supreme Court interpreted the scope of the commerce clause and how that impacted the legislative proposals and programs of Franklin Delano Roosevelt during the Great Depression.
3. Describe both the wider use of the commerce clause from World War II through the 1990s and the limitations the Supreme Court imposed in *Lopez* and other cases.

The Commerce Clause

Introduction: A Farmer and His Wheat

Imagine a farmer named Frank who grows wheat on his small family farm in Kansas. He grows enough to sell a little at the local grain elevator but also keeps a portion for his family's use—to bake bread, feed his chickens, and seed his fields for the next year. Frank never ships his wheat across state lines. One day, however, federal inspectors arrive and inform him that under a federal law designed to stabilize wheat prices nationwide, he is growing more wheat than permitted—even the wheat he planned to use only on his farm. Frank is baffled: *How could Congress regulate wheat that never left Kansas, let alone his farm?*

This scenario is based on the real Supreme Court case **Wickard v. Filburn (1942)**, one of the most famous cases interpreting the **Commerce Clause**. The case illustrates just how far Congress's power under this clause can reach.

The Constitutional Basis

The **Commerce Clause** is found in **Article I, Section 8, Clause 3** of the U.S. Constitution. It provides that:

> ***"The Congress shall have Power... To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."***

Although the clause is short, it has been the foundation for an enormous amount of federal legislation. Congress has used it to regulate not only the movement of goods across state lines but also labor relations, civil rights, environmental law, and even certain aspects of health care.

Early Interpretations

In the 19th and early 20th centuries, the Supreme Court interpreted the Commerce Clause narrowly. Congress could regulate the shipment of goods **across state lines**, but activities considered **purely local** were left to the states.

- **Hammer v. Dagenhart (1918):** Congress passed a law prohibiting the shipment of goods made with child labor across state lines. The Court struck it down, holding that manufacturing was a local activity and therefore beyond Congress's reach.

At this stage, the Commerce Clause was seen as a limited tool—Congress could keep harmful products out of interstate commerce, but it could not regulate local working conditions or production itself.

The New Deal Era and Expansion

During the **Great Depression of the 1930s**, the federal government sought to take a more active role in regulating the economy. Congress passed the **National Labor Relations Act (NLRA)** and other laws aimed at stabilizing industry and protecting workers.

- **NLRB v. Jones & Laughlin Steel Corp. (1937):** The Court upheld the NLRA, reasoning that labor disputes at a large steel plant had a "close and substantial relation" to interstate commerce. If steel workers went on strike, it would disrupt production and affect trade across state lines.

This decision marked a turning point: the Court began recognizing that even activities that looked "local" could have significant effects on interstate commerce.

The Substantial Effects Doctrine

The principle that emerged was that **Congress may regulate any activity that has a substantial effect on interstate commerce**, even if the activity itself is intrastate and seemingly local.

- **Wickard v. Filburn (1942):** Returning to Frank and his wheat, the Court ruled that even though the wheat never entered interstate commerce, it still affected the national wheat market. By growing his own, Frank reduced the amount of wheat he would buy, and if many farmers did the same, the overall supply-and-demand balance would be disrupted. Thus, Congress could regulate Frank's wheat under the Commerce Clause.

Civil Rights and Commerce

The Commerce Clause also became a crucial tool for advancing **civil rights**.

- **Heart of Atlanta Motel v. United States (1964):** A motel in Georgia refused to rent rooms to African Americans. Congress had passed the **Civil Rights Act of 1964**, which prohibited such discrimination in public accommodations. The motel argued it was a local business. The Court disagreed, noting that many of its guests came from out of state and that racial discrimination placed burdens on interstate travel. The law was upheld under the Commerce Clause.

Here, the Court confirmed that Congress could use the Commerce Clause not only for economic regulation but also to address broader social issues tied to commerce.

Limits on the Commerce Power

From the 1940s to the 1990s, the Supreme Court rarely struck down federal laws based on the Commerce Clause. Congress could almost always point to some connection, however small, to interstate commerce. But in the mid-1990s, the Court began to push back.

- **United States v. Lopez (1995):** Congress had passed a law banning guns within 1,000 feet of schools, claiming it related to commerce because education affects the economy. The Court struck the law down, holding that carrying a gun near a school was too far removed from interstate commerce to justify federal regulation.
- **United States v. Morrison (2000):** The Court invalidated part of the **Violence Against Women Act**, ruling that gender-motivated crimes of violence were not economic activity and could not be regulated by Congress under the Commerce Clause.

These cases showed that there are limits: Congress cannot use the Commerce Clause as a blanket authority to regulate anything it wishes.

Modern Applications

Despite these limits, the Commerce Clause remains one of Congress's most powerful tools. It supports federal regulation in areas such as:

- **Environmental protection** (e.g., pollution that crosses state lines)
- **Consumer protection** (e.g., food and drug safety)
- **Labor and employment law** (e.g., minimum wage, workplace safety)
- **Health care** (e.g., the Affordable Care Act's provisions)

The Court continues to balance state and federal powers, but the basic rule is clear: **Congress may regulate interstate commerce and activities that substantially affect it.**

KEY TAKEAWAY

The **Commerce Clause** gives Congress the power to regulate trade across state and national boundaries. Over time, the Supreme Court has expanded its meaning from regulating only goods in transit to covering nearly any activity with a substantial effect on interstate commerce. While there are modern limits, it remains the constitutional foundation for much of federal economic and social legislation.

EXERCISES

1. Why would Congress have power under the Civil Rights Act of 1964 to require restaurants and hotels to not discriminate against interstate travelers on the basis of race, color, sex, religion, or national origin? Suppose the Holiday Restaurant near I-80 in Des Moines, Iowa, has a sign that says, "We reserve the right to refuse service to any Muslim or person of Middle Eastern descent." Suppose also that the restaurant is very popular locally and that only 40 percent of its patrons are travelers on I-80. Are the owners of the Holiday Restaurant in violation of the Civil Rights Act of 1964? What would happen if the owners resisted enforcement by claiming that Title II of the act (relating to "public accommodations" such as hotels, motels, and restaurants) was unconstitutional?
2. If the Supreme Court were to go back to the days of *Hammer v. Dagenhart* and rule that only goods and services involving interstate movement could be subject to federal law, what kinds of federal programs might be lacking a sound basis in the commerce clause? "Obamacare"? Medicare? Homeland security? Social Security? What other powers are granted to Congress under the Constitution to legislate for the general good of society?

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4.3: Dormant Commerce Clause

LEARNING OBJECTIVES

1. Understand that when Congress does not exercise its powers under the commerce clause, the Supreme Court may still limit state legislation that discriminates against interstate commerce or places an undue burden on interstate commerce.
2. Distinguish between “discrimination” dormant-commerce-clause cases and “undue burden” dormant-commerce-clause cases.

The Dormant Commerce Clause

Introduction

Congress has broad power under the **Commerce Clause** to regulate interstate commerce. But what happens when Congress has not acted in a particular area? States retain their **police powers**—the authority to regulate for the health, safety, welfare, and morals of their citizens. Yet state regulations cannot interfere with the free flow of commerce across state lines. Out of this tension, the Supreme Court developed the doctrine known as the **Dormant Commerce Clause** (sometimes called the “negative” Commerce Clause).

This doctrine is not written explicitly in the Constitution. Instead, it is a judicially created principle that limits state action when it discriminates against or unduly burdens interstate commerce. The central idea is that the Constitution gave **Congress**, not the states, the ultimate authority over interstate trade, and therefore states must not obstruct it.

Key Principles

1. **Legitimate State Interests:**
   States may regulate local matters—such as health, safety, and environmental concerns—under their traditional police powers.

2. **No Discrimination:**
   States cannot pass laws that discriminate against out-of-state businesses in favor of local ones. A state cannot, for example, give its own producers a competitive advantage by making it harder for out-of-state goods to enter its market.

3. **No Undue Burdens:**
   Even if a law is neutral on its face, it may be struck down if the burden it imposes on interstate commerce outweighs its local benefits.

The Balancing Test

When evaluating a state law under the Dormant Commerce Clause, the Supreme Court applies a **balancing test**:

- The Court weighs the **state’s legitimate interest** in regulating the matter (such as protecting public health, the environment, or consumer safety)
  against

- The **burden** that the regulation places on interstate commerce.
- If the state’s interest is strong and the burden minimal, the law may be upheld.
- If the burden clearly outweighs the local benefits, the law will be struck down.

Examples in Action

1. Undue Burden – Kassel v. Consolidated Freightways (1981)
Iowa prohibited trucks longer than sixty-five feet from using its highways, even though most other states allowed longer trucks. Trucking companies challenged the law, arguing it forced costly detours and delays. The Supreme Court agreed, finding the Iowa law imposed an **undue burden** on interstate commerce with only minimal safety benefits.

2. Discrimination – Oregon Waste Systems v. Department of Environmental Quality (1994)
Oregon charged higher fees for disposing of out-of-state waste than for in-state waste. The Court struck the law down, holding it was **facial discrimination** against interstate commerce. States cannot treat goods differently simply because they come from outside the state.

3. Place-of-Origin Restrictions – Fort Gratiot Sanitary Landfill v. Michigan Department of Natural Resources (1992)
Michigan allowed counties to forbid the disposal of out-of-county waste. The Court invalidated the law, reasoning that if every county exercised that right, out-of-state waste would effectively be excluded from Michigan—discrimination based on origin.

4. Direct Discrimination – Granholm v. Heald (2005)
Michigan and New York allowed in-state wineries to ship directly to consumers but restricted out-of-state wineries. The Court struck down both laws, ruling that they discriminated against interstate commerce. States could regulate wine sales, but they had to do so in a nondiscriminatory manner.

Case Study: Michigan's "Unwelcome Waste"

The Dormant Commerce Clause often intersects with environmental concerns. In the early 2000s, Michigan faced a flood of trash imports, particularly from Toronto, Canada. Senator Carl Levin highlighted that **65 trucks per day** carried Canadian waste into Michigan, threatening landfill capacity and environmental safety.

Although Michigan's residents and lawmakers wanted to block out-of-state trash, the Supreme Court had already made clear that **states cannot ban imports of waste simply because it comes from another jurisdiction**. Garbage is considered "commerce," and discriminatory restrictions violate the Dormant Commerce Clause. Only Congress could authorize states to close their borders to out-of-state waste, but it had declined to do so.

KEY TAKEAWAY

The **Dormant Commerce Clause** prevents states from interfering with interstate commerce in ways that discriminate against or unduly burden out-of-state businesses. Courts apply a **balancing test**: weighing the state's legitimate regulatory interest against the burden imposed on interstate commerce. While states may regulate for health, safety, and welfare, they must do so in a nondiscriminatory and balanced manner that preserves the free flow of trade among the states.

EXERCISES

1. Suppose that the state of New Jersey wishes to limit the amount of hazardous waste that enters into its landfills. The general assembly in New Jersey passes a law that specifically forbids any hazardous waste from entering into the state. All landfills are subject to tight regulations that will allow certain kinds of hazardous wastes originating in New Jersey to be put in New Jersey landfills but that impose significant criminal fines on landfill operators that accept out-of-state hazardous waste. The Baldessari Brothers Landfill in Linden, New Jersey, is fined for taking hazardous waste from a New York State transporter and appeals that ruling on the basis that New Jersey's law is unconstitutional. What is the result?
2. The state of Arizona determines through its legislature that trains passing through the state cannot be longer than seventy cars. There is some evidence that in Eastern US states longer trains pose some safety hazards. There is less evidence that long trains are a problem in Western states. Several major railroads find the Arizona legislation costly and burdensome and challenge the legislation after applied-for permits for longer trains are denied. What kind of dormant commerce clause challenge is this, and what would it take for the challenge to be successful?

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4.4: Preemption- The Supremacy Clause

LEARNING OBJECTIVES

1. Understand the role of the supremacy clause in the balance between state and federal power.
2. Give examples of cases where state legislation is preempted by federal law and cases where state legislation is not preempted by federal law.

The Supremacy Clause and Federal Preemption

Introduction

Imagine the city of Berkeley, California, declaring itself a **"nuclear-free zone"** and attempting to ban the movement of nuclear materials through its borders. While this might express strong local sentiment, such a law would not survive constitutional review. Why? Because Congress, acting under its **Commerce Clause powers**, created the **Nuclear Regulatory Commission (NRC)** in the 1950s and gave it exclusive authority to regulate nuclear safety and liability. Under the **Supremacy Clause** of the U.S. Constitution, federal law preempts conflicting state or local law.

The Supremacy Clause

Article VI of the Constitution provides:

> "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof...shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding."

This clause establishes that federal law—whether a statute passed by Congress or a regulation issued by a federal agency—supersedes conflicting state laws.

Types of Preemption

Preemption can be either **express** or **implied**:

1. **Express Preemption**
   - Congress may clearly state that federal law overrides state law in a given field.
   - *Example:* In nuclear regulation, Congress expressly preempted state safety standards. States cannot impose their own requirements on nuclear facilities.
2. **Implied Preemption**
   - Even when Congress does not explicitly preempt state law, preemption may still be found if:
     - **Conflict Preemption:** It is impossible to comply with both state and federal law, or the state law interferes with federal objectives.
     - **Field Preemption:** Federal regulation is so pervasive that courts conclude Congress intended to "occupy the field," leaving no room for state laws.

Case Examples

- **Pennsylvania v. Nelson (1956):** The Court struck down a Pennsylvania sedition law because federal sedition laws "occupied the field," leaving no room for state regulation.

- **Silkwood v. Kerr-McGee (1984):** A $10 million punitive damages award against a nuclear power company was upheld. Although nuclear safety regulation was federally preempted, Congress had not intended to preempt state tort remedies. This shows courts can distinguish between regulatory preemption and the preservation of traditional state law remedies.
- **Cipollone v. Liggett Group (1993):** Rose Cipollone's family sued cigarette companies for wrongful death. Federal cigarette labeling laws from the 1960s contained express preemption language: "No requirement based on smoking and health shall be imposed under state law with respect to the advertising and promotion of cigarettes." The Court ruled that some state tort claims (such as failure-to-warn claims) were preempted, while others (such as fraudulent misrepresentation) could proceed.

When States Can Go Further

Not all federal laws completely preempt state action. Congress sometimes allows states to adopt stricter standards.

- **Example: California Auto Emissions Standards**
  Under the Clean Air Act, California is permitted to adopt stricter automobile emission standards than federal law requires. Other states may choose to follow either federal standards or California's standards, but not create their own. This has led automakers to manufacture both "federal cars" and "California cars."

Industry and Preemption

Interestingly, large industries often **prefer national regulation** to a patchwork of state laws. Lobbying Congress in Washington, D.C., is easier than lobbying fifty separate state legislatures. For instance, the tobacco industry pushed for federal warning-label laws, in part because it meant state-law claims about failure to warn would be preempted.

KEY TAKEAWAY

Under the **Supremacy Clause**, federal law preempts conflicting state law. Preemption may be **express** (Congress says so explicitly) or **implied** (when federal law occupies the field or state law conflicts with federal objectives). Courts look carefully at congressional intent: sometimes state remedies survive (as in *Silkwood*), while in other cases federal law shuts the door on state regulation (as in *Cipollone*).

EXERCISES

1. For many years, the United States engaged in discussions with friendly nations as to the reciprocal use of ports and harbors. These discussions led to various multilateral agreements between the nations as to the configuration of oceangoing vessels and how they would be piloted. At the same time, concern over oil spills in Puget Sound led the state of Washington to impose fairly strict standards on oil tankers and requirements for the training of oil tanker pilots. In addition, Washington's state law imposed many other requirements that went above and beyond agreed-upon requirements in the international agreements negotiated by the federal government. Are the Washington state requirements preempted by federal law?
2. The Federal Arbitration Act of 1925 requires that all contracts for arbitration be treated as any other contract at common law. Suppose that the state of Alabama wishes to protect its citizens from a variety of arbitration provisions that they might enter into unknowingly. Thus the legislation provides that all predispute arbitration clauses be in bold print, that they be of twelve-point font or larger, that they be clearly placed within the first two pages of any contract, and that they have a separate signature line where the customer, client, or patient acknowledges having read, understood, and signed the arbitration clause in addition to any other signatures required on the contract. The legislation does preserve the right of consumers to litigate in the event of a dispute arising with the product or service provider; that is, with this legislation, consumers will not unknowingly waive their right to a trial at common law. Is the Alabama law preempted by the Federal Arbitration Act?

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4.5: Business and the Bill of Rights

LEARNING OBJECTIVES

1. Understand and describe which articles in the Bill of Rights apply to business activities and how they apply.
2. Explain the application of the Fourteenth Amendment—including the due process clause and the equal protection clause—to various rights enumerated in the original Bill of Rights.

Business and the Bill of Rights

We have already seen the Fourteenth Amendment's application in **Burger King v. Rudzewicz** (Section 3.9). In that case, the Court considered whether it was constitutionally proper for a state court to assert personal jurisdiction over a nonresident defendant. The Court held that states cannot constitutionally award a judgment against a nonresident if doing so would offend "traditional notions of fair play and substantial justice." Even if the state's long-arm statute seems to allow such a judgment, other states are not constitutionally required to give it full faith and credit under Article IV of the Constitution. In short, a state's statute cannot create personal jurisdiction where the Constitution forbids it.

The Bill of Rights and Selective Incorporation

The **Bill of Rights** (the first ten amendments to the U.S. Constitution) was originally intended to apply only to actions by the federal government. For much of the 19th century, state governments were free to adopt their own rules regarding speech, religion, searches, and criminal trials. That changed during the twentieth century.

Through a process the Court calls **selective incorporation**, many of the guarantees in the Bill of Rights have been applied to the states through the **due process clause of the Fourteenth Amendment**. For example, originally the **Fourth Amendment**'s protections against unreasonable searches and seizures applied only to federal agents. But in **Mapp v. Ohio (1960)**, the Supreme Court held that state agents must also comply with the same restrictions, ensuring that evidence seized illegally by state officers could not be used in state courts.

Today, most—but not all—of the Bill of Rights applies to the states. For example, the **Third Amendment** (quartering of soldiers) and the requirement of a **grand jury indictment** in the Fifth Amendment have not been incorporated against the states.

Key Principles to Remember

1. **Government Action Only:**
   The Bill of Rights applies to **government action** (federal or state), not to private actors. For example, a city government cannot shut down a newspaper because it dislikes its political views, but a private employer can prohibit employees from speaking to the media during work hours.

2. **State Action and Private Entities:**
   In rare cases, a private entity may be treated as if it were the government if it is so closely connected to state or federal action that constitutional rules must apply.

   - **Example:** A private defense contractor doing 90 percent of its business with the federal government was considered to be engaged in "state action" for purposes of free speech rights.
   - **Counterexample:** In **Jackson v. Metropolitan Edison Co. (1974)**, the Court rejected the claim that a heavily regulated private utility company was a "state actor." The utility did not have to give a hearing before cutting off electricity for nonpayment.

3. **States' Rights and Sovereignty:**
   The balance of power between states and the federal government remains a central constitutional issue. For instance, in **Kimel v. Florida Board of Regents (2000)**, the Court held that states were immune from certain lawsuits under the **Eleventh Amendment**, limiting the application of some federal employment discrimination laws against states.

First Amendment

Freedom of Speech

The First Amendment declares that **"Congress shall make no law...abridging the freedom of speech, or of the press."** The Founding Fathers believed democracy required open and vigorous debate. Citizens needed to be able to criticize their leaders, publish dissenting views, and engage in political discourse without fear of censorship.

However, the First Amendment was never meant to be absolute. Justice **Oliver Wendell Holmes's** famous dictum illustrates this: the law does not permit you to shout "Fire!" in a crowded theater when there is no fire. Speech that causes panic, violence, or other immediate harm can be restricted. Likewise, **defamation laws** (for libel and slander) survived the adoption of the Bill of Rights; no one believed the framers intended to abolish protections against false and damaging statements.

Types of Speech

Courts distinguish among different categories of speech, with **political speech** receiving the strongest protection and other forms, such as **commercial speech** or **obscene speech**, subject to greater regulation:

1. **Political Speech:**
   - The "core" of the First Amendment.
   - May include harsh, false, or misleading statements about public officials or public figures.
   - Example: A politician accused of corruption in an editorial has little recourse unless they can prove the statement was made with **actual malice**—knowledge of falsity or reckless disregard for the truth (*New York Times v. Sullivan*, 1964).
2. **Commercial Speech:**
   - Includes advertising and business-related communication.
   - Receives protection but can be regulated to prevent false or misleading claims, or to promote important government interests (e.g., public health).
   - Example: A key case in this area is **Bad Frog Brewery, Inc. v. New York State Liquor Authority**. Bad Frog Brewery applied for approval to sell beer with a label featuring a cartoon frog giving the middle finger. New York's Liquor Authority denied approval, claiming the label was "obscene and offensive" and should be restricted to protect children. The appellate court disagreed, holding that the state's ban failed the Central Hudson test. While shielding minors from vulgar images is a substantial interest, banning the label did not materially advance that goal, since children are routinely exposed to similar or worse imagery in society. Moreover, the outright ban was broader than necessary—less restrictive alternatives existed, such as limiting advertising to places where children were not likely to be present. The case illustrates how courts carefully weigh restrictions on commercial speech and often strike them down when they are overly broad or ineffective.
3. **Time, Place, and Manner Restrictions:**
   - The government may impose reasonable restrictions on how speech occurs, so long as the restrictions are content-neutral.
   - Example: Cities may require parade permits, limit noise levels for protests, or restrict leafletting in airports to maintain order and safety.
4. **Obscene Speech:**
   - Obscenity, as defined by the Court, is not protected. The test comes from **Miller v. California (1973)**, which asks whether the material appeals to prurient interest, depicts sexual conduct in an offensive way, and lacks serious literary, artistic, political, or scientific value.

Freedom of Religion

The First Amendment protects not only speech and press but also religious liberty. It does this through **two distinct but related provisions**: the **Establishment Clause** and the **Free Exercise Clause**. Together, they aim to ensure that government neither promotes religion nor interferes with individuals' right to practice their faith.

Establishment Clause

The **Establishment Clause** prohibits the government from establishing an official religion or favoring one religion over another. Thomas Jefferson famously described this protection as creating a "wall of separation between church and state." Over time, the Supreme Court has developed a variety of tests and precedents to determine when government action crosses the line into unconstitutional establishment of religion.

- **School Prayer Cases**: In *Engel v. Vitale* (1962), the Court struck down state-sponsored prayer in public schools, even if voluntary, reasoning that official prayer by government officials violated the Establishment Clause. Later cases extended this to Bible readings and graduation prayers.
- **Religious Displays**: The Court has reached mixed results when it comes to public religious displays. In *County of Allegheny v. ACLU* (1989), a courthouse nativity scene was ruled unconstitutional because it promoted a specific religion. However, displays including multiple religious and secular symbols—such as menorahs, Christmas trees, and Santa Claus—have been upheld, as they were found to celebrate the holiday season broadly rather than endorse a single faith.
- **Government Funding**: In *Everson v. Board of Education* (1947), the Court upheld a state program reimbursing parents for bus transportation to both public and parochial schools, noting that the aid was neutral and designed to benefit all students, not advance religion. This case was an early example of how neutrality is key in Establishment Clause analysis.
- **The Lemon Test**: In *Lemon v. Kurtzman* (1971), the Court set out a three-part test to evaluate Establishment Clause cases. A law is unconstitutional if (1) it lacks a secular legislative purpose, (2) its principal effect advances or inhibits religion, or (3) it fosters excessive government entanglement with religion. While later cases have modified or criticized the test, it remains an important framework in Establishment Clause jurisprudence.

Free Exercise Clause

The **Free Exercise Clause** guarantees individuals the right to practice their religion freely. This right, however, is not absolute, especially when religious practices conflict with general laws.

- **Neutral Laws of General Applicability**: In *Employment Division v. Smith* (1990), the Court held that Oregon could deny unemployment benefits to two men fired for using peyote in a Native American religious ritual. The decision emphasized that laws that are neutral and apply to everyone—even if they incidentally burden religious practice—do not violate the Free Exercise Clause.
- **Religious Freedom Restoration Act (RFRA)**: In response to *Smith*, Congress passed RFRA, requiring courts to apply strict scrutiny when government action substantially burdens religious exercise. Under this framework, the government must prove that the law serves a compelling interest and is narrowly tailored. In *Burwell v. Hobby Lobby* (2014), the Court applied RFRA to allow closely held corporations to refuse to provide contraceptive coverage under the Affordable Care Act when doing so conflicted with the owners' religious beliefs.
- **Modern Applications**: Conflicts between religious liberty and anti-discrimination laws continue to shape Free Exercise jurisprudence. In *Masterpiece Cakeshop v. Colorado Civil Rights Commission* (2018), the Court ruled in favor of a baker who declined to make a wedding cake for a same-sex couple, holding that the state commission had shown hostility toward the baker's religious beliefs. While the decision was narrow, it underscored the principle that government must remain neutral when regulating religious practices.

Fourth Amendment

The Fourth Amendment states:

> "The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized."

The Court has interpreted this protection to prohibit only those government searches or seizures that are **"unreasonable."** What is considered reasonable often depends on context, and courts balance the government's interests against an individual's or business's expectation of privacy.

Closely Regulated Industries

Businesses operating in **"closely regulated" industries**—such as liquor sales, firearms, mining, or automobile junkyards—may be subject to warrantless inspections because of the heightened public interest in monitoring those activities.

- **Example – Junkyards:** In *New York v. Burger (1987)*, an auto junkyard owner argued that a warrantless inspection that uncovered stolen vehicle parts violated the Fourth Amendment. The Supreme Court disagreed, holding that junkyards are a closely regulated industry where surprise inspections are necessary to combat auto theft.
- **Other examples:** Liquor stores and gun shops are subject to periodic inspections for public safety. Similarly, federal mine inspectors may enter without advance notice to ensure worker safety.

Open Fields and Aerial Surveillance

The Fourth Amendment specifically protects "persons, houses, papers, and effects," but **open fields** fall outside its scope. What is exposed to the public eye—even from the air—often carries no reasonable expectation of privacy.

- **Example – Dow Chemical:** The EPA flew over Dow Chemical's Midland, Michigan, plant in the 1980s and took aerial photographs of machinery and chemical ponds. Because the objects were in "open fields," the Court ruled the search permissible.
- **Example – *California v. Ciraolo (1986):*** Police flew over a man's backyard at 1,000 feet and saw marijuana plants. The Court ruled no warrant was required since the plants were visible from lawful airspace.
- **Example – *Florida v. Riley (1989):*** Police observed marijuana in a greenhouse from a helicopter at 400 feet. Again, the Court allowed the evidence, holding that what is visible from public airspace is not private.

Car Searches

Unlike homes, cars are **mobile** and subject to a lower expectation of privacy, meaning police have broader authority to search them without a warrant. Key circumstances include:

- **Consent:** If you voluntarily allow police to search your vehicle, they may do so without a warrant (*Schneckloth v. Bustamonte, 1973*).
- **Plain View:** If officers lawfully stop you and see contraband in plain sight—like drugs on the dashboard—they may seize it (*Texas v. Brown, 1983*).
- **Search Incident to Arrest:** If you are lawfully arrested, police may search the area within your immediate control, including parts of your car, to protect officer safety or preserve evidence (*Arizona v. Gant, 2009*).
- **Probable Cause (Automobile Exception):** If police have probable cause to believe your car contains evidence of a crime, they may search it without a warrant (*Carroll v. United States, 1925*).
- **Inventory Searches:** If your car is impounded, police may search it to catalog its contents, both to protect your property and shield themselves from liability (*South Dakota v. Opperman, 1976*).

Government vs. Private Action

It is critical to remember that the Fourth Amendment restricts **only government action**. Private employers or companies are not bound by its requirements.

- **Example – Drug Testing:** A public agency (like a police department) requiring weekly drug testing could be challenged as an unreasonable search. By contrast, a private company may require the same, but employees have no Fourth Amendment claim—they must rely on labor laws or contracts.
- **Example – Public vs. Private Schools:** In *New Jersey v. T.L.O. (1985)*, a public high school official searched a student's purse and found marijuana. Because the school was a government actor, the Fourth Amendment applied—though under a reduced standard of reasonableness. In contrast, a search by staff at a private school would not implicate the Fourth Amendment at all.
- **Example – Student Lockers:** In *Vernonia School District v. Acton (1995)* and later cases, the Court emphasized that students have a diminished expectation of privacy in schools. Many courts have upheld **locker searches** because lockers are school property and students are on notice that lockers may be inspected for safety or disciplinary reasons. If contraband like weapons or drugs is found during a random locker check, the search is typically considered reasonable under the Fourth Amendment.

Fifth Amendment

The Fifth Amendment to the U.S. Constitution states:

> "No person shall be...deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."

The Fifth Amendment provides several important protections: the right to **due process**, the prohibition against **self-incrimination**, the guarantee against **double jeopardy**, and the **takings clause** (just compensation when government takes private property for public use).

Self-Incrimination and Miranda Rights

One of the most familiar aspects of the Fifth Amendment is its protection against self-incrimination. You cannot be forced to testify against yourself in a criminal case.

- **Miranda v. Arizona (1966):** The Supreme Court held that individuals taken into custody must be informed of their rights before interrogation. These warnings—commonly called **Miranda Rights**—include the right to remain silent, the warning that anything said can be used in court, and the right to an attorney (appointed if the suspect cannot afford one).

If police fail to give these warnings before custodial interrogation, statements made may be excluded from trial.

Example: If a suspect confesses to a crime during a custodial police interrogation without being advised of Miranda rights, the confession is inadmissible in court.

Key Point: Miranda only applies when both *custody* and *interrogation* are present. If you voluntarily talk to police before being detained, Miranda protections do not apply.

Double Jeopardy

The Fifth Amendment also protects against **double jeopardy**, meaning a person cannot be tried twice for the same offense in the same jurisdiction.

- **Example:** If you are acquitted of theft in state court, the state cannot try you again for the same theft.
- However, state and federal governments are considered separate sovereigns. So, a person acquitted in state court could still face federal charges for the same underlying conduct if it violates federal law (*e.g.,* drug trafficking or civil rights violations).

Due Process

The Fifth Amendment includes a **due process guarantee**, ensuring fair procedures before the government can deprive someone of life, liberty, or property.

- **Procedural Due Process:** Requires notice and an opportunity to be heard. For example, before being fired from a public job with tenure, an employee is entitled to a hearing.
- **Substantive Due Process:** Protects certain fundamental rights (like privacy or marriage) from government interference, even if proper procedures are followed.

Takings Clause

The **Takings Clause** of the Fifth Amendment ensures that when the government takes private property for public use, it must provide **just compensation**.

- **Example – Eminent Domain:** If the government condemns private land to build a highway, the owner must be fairly compensated at market value.
- **Kelo v. City of New London (2005):** The Court upheld the city's decision to use eminent domain to take private homes and

transfer the land to a private developer, reasoning that economic development qualified as a "public use." This decision was controversial and led many states to pass laws narrowing the scope of eminent domain.

Fourteenth Amendment: Due Process and Equal Protection

Ratified in 1868, the **Fourteenth Amendment** reshaped the relationship between the federal government, state governments, and individual citizens. Its most important provisions include the **Due Process Clause** and the **Equal Protection Clause**:

- **Due Process Clause:** "Nor shall any State deprive any person of life, liberty, or property, without due process of law."
- **Equal Protection Clause:** "Nor deny to any person within its jurisdiction the equal protection of the laws."

These clauses mean that states must follow fair procedures, respect fundamental rights, and treat people equally under the law.

Due Process

The Fourteenth Amendment's Due Process Clause extends the protections of the Bill of Rights to actions by state governments. It has two components:

1. **Procedural Due Process** – The government must follow fair procedures before depriving a person of life, liberty, or property.
    - *Example:* A public university student facing expulsion must receive notice and a hearing before being removed.
2. **Substantive Due Process** – Certain fundamental rights are protected against government interference, even if procedures are fair.
    - *Example:* In *Griswold v. Connecticut (1965)*, the Court recognized a constitutional right to marital privacy, striking down a state law banning contraceptives.

Equal Protection

The **Equal Protection Clause** requires that states treat similarly situated individuals alike. But not all classifications by government are unconstitutional. Courts apply different levels of scrutiny depending on the type of classification.

1. Minimal (Rational Basis) Scrutiny

Government action will be upheld if it is **rationally related to a legitimate government interest.** This is the most deferential standard.

- **Example:** In *Williamson v. Lee Optical (1955)*, the Court upheld an Oklahoma law requiring people to get prescriptions from an eye doctor before having lenses fitted, even though opticians argued it was unnecessary. The Court found the law rationally related to protecting public health.

2. Intermediate Scrutiny

Government classifications based on **gender or legitimacy** must be **substantially related to an important government objective.**

- **Example:** In *Craig v. Boren (1976)*, the Court struck down an Oklahoma law that allowed women to buy low-alcohol beer at age 18 but required men to be 21, ruling it violated equal protection because it was not substantially related to traffic safety.

3. Strict Scrutiny

Government classifications based on **race, ethnicity, or those burdening fundamental rights** must be **narrowly tailored to achieve a compelling government interest.** This is the toughest standard, and laws rarely survive it.

- **Example:** In *Brown v. Board of Education (1954)*, racial segregation in public schools was struck down because "separate but equal" was not a compelling justification for denying equal educational opportunities.

- Another example: Laws restricting the right to travel or to vote would also trigger strict scrutiny.

KEY TAKEAWAY

The Bill of Rights, through the Fourteenth Amendment, largely applies to state actions. The Bill of Rights has applied to federal actions from the start. Both the Bill of Rights and the Fourteenth Amendment apply to business in various ways, but it is important to remember that the rights conferred are rights against governmental action and not the actions of private enterprise.

EXERCISES

1. John Hanks works at ProLogis. The company decides to institute a drug-testing policy. John is a good and longtime employee but enjoys smoking marijuana on the weekends. The drug testing will involve urine samples and, semiannually, a hair sample. It is nearly certain that the drug-testing protocol that ProLogis proposes will find that Hanks is a marijuana user. The company has made it clear that it will have zero tolerance for any kind of nonprescribed controlled substances. John and several fellow employees wish to go to court to challenge the proposed testing as “an unreasonable search and seizure.” Can he possibly succeed?
2. Larry Reed, majority leader in the Senate, is attacked in his reelection campaign by a series of ads sponsored by a corporation (Global Defense, Inc.) that does not like his voting record. The corporation is upset that Reed would not write a special provision that would favor Global Defense in a defense appropriations bill. The ads run constantly on television and radio in the weeks immediately preceding election day and contain numerous falsehoods. For example, in order to keep the government running financially, Reed found it necessary to vote for a bill that included a last-minute rider that defunded a small government program for the handicapped, sponsored by someone in the opposing party that wanted to privatize all programs for the handicapped. The ad is largely paid for by Global Defense and depicts a handicapped child being helped by the existing program and large letters saying “Does Larry Reed Just Not Care?” The ad proclaims that it is sponsored by Citizens Who Care for a Better Tomorrow. Is this protected speech? Why or why not? Can Reed sue for defamation? Why or why not?

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4.6: Cases

Griswold v. Connecticut

Griswold v. Connecticut

381 U.S. 479 (U.S. Supreme Court 1965)

A nineteenth-century Connecticut law made the use, possession, or distribution of birth control devices illegal. The law also prohibited anyone from giving information about such devices. The executive director and medical director of a planned parenthood association were found guilty of giving out such information to a married couple that wished to delay having children for a few years. The directors were fined $100 each.

They appealed throughout the Connecticut state court system, arguing that the state law violated (infringed) a basic or fundamental right of privacy of a married couple: to live together and have sex together without the restraining power of the state to tell them they may legally have intercourse but not if they use condoms or other birth control devices. At each level (trial court, court of appeals, and Connecticut Supreme Court), the Connecticut courts upheld the constitutionality of the convictions.

Plurality Opinion by Justice William O. Douglass

We do not sit as a super legislature to determine the wisdom, need, and propriety of laws that touch economic problems, business affairs, or social conditions. The [Connecticut] law, however, operates directly on intimate relation of husband and wife and their physician's role in one aspect of that relation.

[Previous] cases suggest that specific guarantees in the Bill of Rights have penumbras, formed by emanations from those guarantees that help give them life and substance....Various guarantees create zones of privacy. The right of association contained in the penumbra of the First Amendment is one....The Third Amendment in its prohibition against the quartering of soldiers "in any house" in time of peace without the consent of the owner is another facet of that privacy. The Fourth Amendment explicitly affirms the "right of the people to be secure in their persons, houses, papers and effects, against unreasonable searches and seizures." The Fifth Amendment in its Self-Incrimination Clause enables the citizen to create a zone of privacy which the government may not force him to surrender to his detriment. The Ninth Amendment provides: "The enumeration in the Constitution, of certain rights, shall not be construed to deny or disparage others retained by the people."

The Fourth and Fifth Amendments were described...as protection against all governmental invasions "of the sanctity of a man's home and the privacies of life." We recently referred in *Mapp v. Ohio*...to the Fourth Amendment as creating a "right to privacy, no less important than any other right carefully and particularly reserved to the people."

[The law in question here], in forbidding the *use* of contraceptives rather than regulating their manufacture or sale, seeks to achieve its goals by having a maximum destructive impact on [the marital] relationship. Such a law cannot stand....Would we allow the police to search the sacred precincts of marital bedrooms for telltale signs of the use of contraceptives? The very idea is repulsive to the notions of privacy surrounding the marital relationship.

We deal with a right of privacy older than the Bill of Rights—older than our political parties, older than our school system. Marriage is a coming together for better or for worse, hopefully enduring, and intimate to the degree of being sacred. It is an association that promotes a way of life, not causes; a harmony in living, not political faiths; a bilateral loyalty, not commercial or social projects. Yet it is an association for as noble a purpose as any involved in our prior decisions.

Mr. Justice Stewart, whom Mr. Justice Black joins, dissenting.

Since 1879 Connecticut has had on its books a law which forbids the use of contraceptives by anyone. I think this is an uncommonly silly law. As a practical matter, the law is obviously unenforceable, except in the oblique context of the present case. As a philosophical matter, I believe the use of contraceptives in the relationship of marriage should be left to personal and private choice, based upon each individual's moral, ethical, and religious beliefs. As a matter of social policy, I think professional counsel about methods of birth control should be available to all, so that each individual's choice can be meaningfully made. But we are not asked in this case to say whether we think this law is unwise, or even asinine. We are asked to hold that it violates the United States Constitution. And that I cannot do.

In the course of its opinion the Court refers to no less than six Amendments to the Constitution: the First, the Third, the Fourth, the Fifth, the Ninth, and the Fourteenth. But the Court does not say which of these Amendments, if any, it thinks is infringed by this Connecticut law.

...

As to the First, Third, Fourth, and Fifth Amendments, I can find nothing in any of them to invalidate this Connecticut law, even assuming that all those Amendments are fully applicable against the States. It has not even been argued that this is a law "respecting an establishment of religion, or prohibiting the free exercise thereof." And surely, unless the solemn process of constitutional adjudication is to descend to the level of a play on words, there is not involved here any abridgment of "the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances." No soldier has been quartered in any house. There has been no search, and no seizure. Nobody has been compelled to be a witness against himself.

The Court also quotes the Ninth Amendment, and my Brother Goldberg's concurring opinion relies heavily upon it. But to say that the Ninth Amendment has anything to do with this case is to turn somersaults with history. The Ninth Amendment, like its companion the Tenth, which this Court held "states but a truism that all is retained which has not been surrendered," *United States v. Darby*, 312 U.S. 100, 124, was framed by James Madison and adopted by the States simply to make clear that the adoption of the Bill of Rights did not alter the plan that the *Federal* Government was to be a government of express and limited powers, and that all rights and powers not delegated to it were retained by the people and the individual States. Until today no member of this Court has ever suggested that the Ninth Amendment meant anything else, and the idea that a federal court could ever use the Ninth Amendment to annul a law passed by the elected representatives of the people of the State of Connecticut would have caused James Madison no little wonder.

What provision of the Constitution, then, does make this state law invalid? The Court says it is the right of privacy "created by several fundamental constitutional guarantees." With all deference, I can find no such general right of privacy in the Bill of Rights, in any other part of the Constitution, or in any case ever before decided by this Court.

At the oral argument in this case we were told that the Connecticut law does not "conform to current community standards." But it is not the function of this Court to decide cases on the basis of community standards. We are here to decide cases "agreeably to the Constitution and laws of the United States." It is the essence of judicial duty to subordinate our own personal views, our own ideas of what legislation is wise and what is not. If, as I should surely hope, the law before us does not reflect the standards of the people of Connecticut, the people of Connecticut can freely exercise their true Ninth and Tenth Amendment rights to persuade their elected representatives to repeal it. That is the constitutional way to take this law off the books.

CASE QUESTIONS

1. Which opinion is the strict constructionist opinion here—Justice Douglas's or that of Justices Stewart and Black?
2. What would have happened if the Supreme Court had allowed the Connecticut Supreme Court decision to stand and followed Justice Black's reasoning? Is it likely that the citizens of Connecticut would have persuaded their elected representatives to repeal the law challenged here?

Wickard v. Filburn

Wickard v. Filburn

317 U.S. 111 (U.S. Supreme Court 1942)

Mr. Justice Jackson delivered the opinion of the Court.

Mr. Filburn for many years past has owned and operated a small farm in Montgomery County, Ohio, maintaining a herd of dairy cattle, selling milk, raising poultry, and selling poultry and eggs. It has been his practice to raise a small acreage of winter wheat, sown in the Fall and harvested in the following July; to sell a portion of the crop; to feed part to poultry and livestock on the farm, some of which is sold; to use some in making flour for home consumption; and to keep the rest for the following seeding.

His 1941 wheat acreage allotment was 11.1 acres and a normal yield of 20.1 bushels of wheat an acre. He sowed, however, 23 acres, and harvested from his 11.9 acres of excess acreage 239 bushels, which under the terms of the Act as amended on May 26, 1941, constituted farm marketing excess, subject to a penalty of 49 cents a bushel, or $117.11 in all.

The general scheme of the Agricultural Adjustment Act of 1938 as related to wheat is to control the volume moving in interstate and foreign commerce in order to avoid surpluses and shortages and the consequent abnormally low or high wheat prices and obstructions to commerce. [T]he Secretary of Agriculture is directed to ascertain and proclaim each year a national acreage allotment for the next crop of wheat, which is then apportioned to the states and their counties, and is eventually broken up into allotments for individual farms.

It is urged that under the Commerce Clause of the Constitution, Article I, § 8, clause 3, Congress does not possess the power it has in this instance sought to exercise. The question would merit little consideration since our decision in United States v. Darby, 312 U.S. 100, sustaining the federal power to regulate production of goods for commerce, except for the fact that this Act extends federal regulation to production not intended in any part for commerce but wholly for consumption on the farm.

Kassel v. Consolidated Freightways Corp.

Kassel v. Consolidated Freightways Corp.

450 U.S. 662 (U.S. Supreme Court 1981)

JUSTICE POWELL announced the judgment of the Court and delivered an opinion, in which JUSTICE WHITE, JUSTICE BLACKMUN, and JUSTICE STEVENS joined.

The question is whether an Iowa statute that prohibits the use of certain large trucks within the State unconstitutionally burdens interstate commerce.

I

Appellee Consolidated Freightways Corporation of Delaware (Consolidated) is one of the largest common carriers in the country: it offers service in 48 States under a certificate of public convenience and necessity issued by the Interstate Commerce Commission. Among other routes, Consolidated carries commodities through Iowa on Interstate 80, the principal east-west route linking New York, Chicago, and the west coast, and on Interstate 35, a major north-south route.

Consolidated mainly uses two kinds of trucks. One consists of a three-axle tractor pulling a 40-foot two-axle trailer. This unit, commonly called a single, or "semi," is 55 feet in length overall. Such trucks have long been used on the Nation's highways. Consolidated also uses a two-axle tractor pulling a single-axle trailer which, in turn, pulls a single-axle dolly and a second single-axle trailer. This combination, known as a double, or twin, is 65 feet long overall. Many trucking companies, including Consolidated, increasingly prefer to use doubles to ship certain kinds of commodities. Doubles have larger capacities, and the trailers can be detached and routed separately if necessary. Consolidated would like to use 65-foot doubles on many of its trips through Iowa.

The State of Iowa, however, by statute, restricts the length of vehicles that may use its highways. Unlike all other States in the West and Midwest, Iowa generally prohibits the use of 65-foot doubles within its borders.

...

Because of Iowa's statutory scheme, Consolidated cannot use its 65-foot doubles to move commodities through the State. Instead, the company must do one of four things: (i) use 55-foot singles; (ii) use 60-foot doubles; (iii) detach the trailers of a 65-foot double and shuttle each through the State separately; or (iv) divert 65-foot doubles around Iowa. Dissatisfied with these options, Consolidated filed this suit in the District Court averring that Iowa's statutory scheme unconstitutionally burdens interstate commerce. Iowa defended the law as a reasonable safety measure enacted pursuant to its police power. The State asserted that 65-foot doubles are more dangerous than 55-foot singles and, in any event, that the law promotes safety and reduces road wear within the State by diverting much truck traffic to other states.

In a 14-day trial, both sides adduced evidence on safety and on the burden on interstate commerce imposed by Iowa's law. On the question of safety, the District Court found that the "evidence clearly establishes that the twin is as safe as the semi." 475 F.Supp. 544, 549 (SD Iowa 1979). For that reason, "there is no valid safety reason for barring twins from Iowa's highways because of their configuration....The evidence convincingly, if not overwhelmingly, establishes that the 65-foot twin is as safe as, if not safer than, the 60-foot twin and the 55-foot semi...."

"Twins and semis have different characteristics. Twins are more maneuverable, are less sensitive to wind, and create less splash

and spray. However, they are more likely than semis to jackknife or upset. They can be backed only for a short distance. The negative characteristics are not such that they render the twin less safe than semis overall. Semis are more stable, but are more likely to 'rear-end' another vehicle."

In light of these findings, the District Court applied the standard we enunciated in *Raymond Motor Transportation, Inc. v. Rice*, 434 U.S. 429 (1978), and concluded that the state law impermissibly burdened interstate commerce: "[T]he balance here must be struck in favor of the federal interests. The *total effect* of the law as a safety measure in reducing accidents and casualties is so slight and problematical that it does not outweigh the national interest in keeping interstate commerce free from interferences that seriously impede it."

The Court of Appeals for the Eighth Circuit affirmed. 612 F.2d 1064 (1979). It accepted the District Court's finding that 65-foot doubles were as safe as 55-foot singles. *Id.* at 1069. Thus, the only apparent safety benefit to Iowa was that resulting from forcing large trucks to detour around the State, thereby reducing overall truck traffic on Iowa's highways. The Court of Appeals noted that this was not a constitutionally permissible interest. It also commented that the several statutory exemptions identified above, such as those applicable to border cities and the shipment of livestock, suggested that the law, in effect, benefited Iowa residents at the expense of interstate traffic. *Id.* at 1070-1071. The combination of these exemptions weakened the presumption of validity normally accorded a state safety regulation. For these reasons, the Court of Appeals agreed with the District Court that the Iowa statute unconstitutionally burdened interstate commerce.

Iowa appealed, and we noted probable jurisdiction. 446 U.S. 950 (1980). We now affirm.

II

It is unnecessary to review in detail the evolution of the principles of Commerce Clause adjudication. The Clause is both a "prolific ' of national power and an equally prolific source of conflict with legislation of the state[s]." *H. P. Hood & Sons, Inc. v. Du Mond*, 336 U.S. 525, 336 U.S. 534 (1949). The Clause permits Congress to legislate when it perceives that the national welfare is not furthered by the independent actions of the States. It is now well established, also, that the Clause itself is "a limitation upon state power even without congressional implementation." *Hunt v. Washington Apple Advertising Comm'n*, 432 U.S. 333 at 350 (1977). The Clause requires that some aspects of trade generally must remain free from interference by the States. When a State ventures excessively into the regulation of these aspects of commerce, it "trespasses upon national interests," *Great A&P Tea Co. v. Cottrell*, 424 U.S. 366, 424 U.S. 373 (1976), and the courts will hold the state regulation invalid under the Clause alone.

The Commerce Clause does not, of course, invalidate all state restrictions on commerce. It has long been recognized that, "in the absence of conflicting legislation by Congress, there is a residuum of power in the state to make laws governing matters of local concern which nevertheless in some measure affect interstate commerce or even, to some extent, regulate it." *Southern Pacific Co. v. Arizona*, 325 U.S. 761 (1945).

The extent of permissible state regulation is not always easy to measure. It may be said with confidence, however, that a State's power to regulate commerce is never greater than in matters traditionally of local concern. *Washington Apple Advertising Comm'n, supra* at 432 U.S. 350. For example, regulations that touch upon safety—especially highway safety—are those that "the Court has been most reluctant to invalidate." *Raymond, supra* at 434 U.S. 443 (and other cases cited). Indeed, "if safety justifications are not illusory, the Court will not second-guess legislative judgment about their importance in comparison with related burdens on interstate commerce." *Raymond, supra* at 434 U.S. at 449. Those who would challenge such bona fide safety regulations must overcome a "strong presumption of validity." *Bibb v. Navajo Freight Lines, Inc.*, 359 U.S. 520 at (1959).

But the incantation of a purpose to promote the public health or safety does not insulate a state law from Commerce Clause attack. Regulations designed for that salutary purpose nevertheless may further the purpose so marginally, and interfere with commerce so substantially, as to be invalid under the Commerce Clause. In the Court's recent unanimous decision in *Raymond* we declined to "accept the State's contention that the inquiry under the Commerce Clause is ended without a weighing of the asserted safety purpose against the degree of interference with interstate commerce." This "weighing" by a court requires—and indeed the constitutionality of the state regulation depends on—"a sensitive consideration of the weight and nature of the state regulatory concern in light of the extent of the burden imposed on the course of interstate commerce." *Id.* at 434 U.S. at 441; *accord, Pike v. Bruce Church, Inc.*, 397 U.S. 137 at 142 (1970); *Bibb, supra*, at 359 U.S. at 525-530.

III

Applying these general principles, we conclude that the Iowa truck length limitations unconstitutionally burden interstate

commerce.

In *Raymond Motor Transportation, Inc. v. Rice*, the Court held that a Wisconsin statute that precluded the use of 65-foot doubles violated the Commerce Clause. This case is *Raymond* revisited. Here, as in *Raymond*, the State failed to present any persuasive evidence that 65-foot doubles are less safe than 55-foot singles. Moreover, Iowa's law is now out of step with the laws of all other Midwestern and Western States. Iowa thus substantially burdens the interstate flow of goods by truck. In the absence of congressional action to set uniform standards, some burdens associated with state safety regulations must be tolerated. But where, as here, the State's safety interest has been found to be illusory, and its regulations impair significantly the federal interest in efficient and safe interstate transportation, the state law cannot be harmonized with the Commerce Clause.

A

Iowa made a more serious effort to support the safety rationale of its law than did Wisconsin in *Raymond*, but its effort was no more persuasive. As noted above, the District Court found that the "evidence clearly establishes that the twin is as safe as the semi." The record supports this finding. The trial focused on a comparison of the performance of the two kinds of trucks in various safety categories. The evidence showed, and the District Court found, that the 65-foot double was at least the equal of the 55-foot single in the ability to brake, turn, and maneuver. The double, because of its axle placement, produces less splash and spray in wet weather. And, because of its articulation in the middle, the double is less susceptible to dangerous "off-tracking," and to wind.

None of these findings is seriously disputed by Iowa. Indeed, the State points to only three ways in which the 55-foot single is even arguably superior: singles take less time to be passed and to clear intersections; they may back up for longer distances; and they are somewhat less likely to jackknife.

The first two of these characteristics are of limited relevance on modern interstate highways. As the District Court found, the negligible difference in the time required to pass, and to cross intersections, is insignificant on 4-lane divided highways, because passing does not require crossing into oncoming traffic lanes, *Raymond*, 434 U.S. at 444, and interstates have few, if any, intersections. The concern over backing capability also is insignificant, because it seldom is necessary to back up on an interstate. In any event, no evidence suggested any difference in backing capability between the 60-foot doubles that Iowa permits and the 65-foot doubles that it bans. Similarly, although doubles tend to jackknife somewhat more than singles, 65-foot doubles actually are less likely to jackknife than 60-foot doubles.

Statistical studies supported the view that 65-foot doubles are at least as safe overall as 55-foot singles and 60-foot doubles. One such study, which the District Court credited, reviewed Consolidated's comparative accident experience in 1978 with its own singles and doubles. Each kind of truck was driven 56 million miles on identical routes. The singles were involved in 100 accidents resulting in 27 injuries and one fatality. The 65-foot doubles were involved in 106 accidents resulting in 17 injuries and one fatality. Iowa's expert statistician admitted that this study provided "moderately strong evidence" that singles have a higher injury rate than doubles. Another study, prepared by the Iowa Department of Transportation at the request of the state legislature, concluded that "[s]ixty-five foot twin trailer combinations have *not* been shown by experiences in other states to be less safe than 60-foot twin trailer combinations *or* conventional tractor-semitrailers."

In sum, although Iowa introduced more evidence on the question of safety than did Wisconsin in *Raymond*, the record as a whole was not more favorable to the State.

B

Consolidated, meanwhile, demonstrated that Iowa's law substantially burdens interstate commerce. Trucking companies that wish to continue to use 65-foot doubles must route them around Iowa or detach the trailers of the doubles and ship them through separately. Alternatively, trucking companies must use the smaller 55-foot singles or 65-foot doubles permitted under Iowa law. Each of these options engenders inefficiency and added expense. The record shows that Iowa's law added about $12.6 million each year to the costs of trucking companies.

Consolidated alone incurred about $2 million per year in increased costs.

In addition to increasing the costs of the trucking companies (and, indirectly, of the service to consumers), Iowa's law may aggravate, rather than, ameliorate, the problem of highway accidents. Fifty-five-foot singles carry less freight than 65-foot doubles. Either more small trucks must be used to carry the same quantity of goods through Iowa or the same number of larger trucks must drive longer distances to bypass Iowa. In either case, as the District Court noted, the restriction requires more highway

miles to be driven to transport the same quantity of goods. Other things being equal, accidents are proportional to distance traveled. Thus, if 65-foot doubles are as safe as 55-foot singles, Iowa's law tends to increase the number of accidents and to shift the incidence of them from Iowa to other States.

[IV. Omitted]

V

In sum, the statutory exemptions, their history, and the arguments Iowa has advanced in support of its law in this litigation all suggest that the deference traditionally accorded a State's safety judgment is not warranted. *See Raymond, supra* at 434 U.S. at 444-447. The controlling factors thus are the findings of the District Court, accepted by the Court of Appeals, with respect to the relative safety of the types of trucks at issue, and the substantiality of the burden on interstate commerce.

Because Iowa has imposed this burden without any significant countervailing safety interest, its statute violates the Commerce Clause. The judgment of the Court of Appeals is affirmed.

It is so ordered.

CASE QUESTIONS

1. Under the Constitution, what gives Iowa the right to make rules regarding the size or configuration of trucks upon highways within the state?
2. Did Iowa try to exempt trucking lines based in Iowa, or was the statutory rule nondiscriminatory as to the origin of trucks that traveled on Iowa highways?
3. Are there any federal size or weight standards noted in the case? Is there any kind of truck size or weight that could be limited by Iowa law, or must Iowa simply accept federal standards or, if none, impose no standards at all?

Hunt v. Washington Apple Advertising Commission

Hunt v. Washington Apple Advertising Commission

432 U.S. 33 (U.S. Supreme Court 1977)

MR. CHIEF JUSTICE BURGER delivered the opinion of the Court.

In 1973, North Carolina enacted a statute which required, inter alia, all closed containers of apples sold, offered for sale, or shipped into the State to bear "no grade other than the applicable U.S. grade or standard."...Washington State is the Nation's largest producer of apples, its crops accounting for approximately 30% of all apples grown domestically and nearly half of all apples shipped in closed containers in interstate commerce. [Because] of the importance of the apple industry to the State, its legislature has undertaken to protect and enhance the reputation of Washington apples by establishing a stringent, mandatory inspection program [that] requires all apples shipped in interstate commerce to be tested under strict quality standards and graded accordingly. In all cases, the Washington State grades [are] the equivalent of, or superior to, the comparable grades and standards adopted by the [U.S. Dept. of] Agriculture (USDA).

[In] 1972, the North Carolina Board of Agriculture adopted an administrative regulation, unique in the 50 States, which in effect required all closed containers of apples shipped into or sold in the State to display either the applicable USDA grade or a notice indicating no classification. State grades were expressly prohibited. In addition to its obvious consequence—prohibiting the display of Washington State apple grades on containers of apples shipped into North Carolina—the regulation presented the Washington apple industry with a marketing problem of potentially nationwide significance. Washington apple growers annually ship in commerce approximately 40 million closed containers of apples, nearly 500,000 of which eventually find their way into North Carolina, stamped with the applicable Washington State variety and grade. [Compliance] with North Carolina's unique regulation would have required Washington growers to obliterate the printed labels on containers shipped to North Carolina, thus giving their product a damaged appearance. Alternatively, they could have changed their marketing practices to accommodate the needs of the North Carolina market, i.e., repack apples to be shipped to North Carolina in containers bearing only the USDA grade, and/or store the estimated portion of the harvest destined for that market in such special containers. As a last resort, they could discontinue the use of the preprinted containers entirely. None of these costly and less efficient options was very attractive

to the industry. Moreover, in the event a number of other States followed North Carolina's lead, the resultant inability to display the Washington grades could force the Washington growers to abandon the State's expensive inspection and grading system which their customers had come to know and rely on over the 60-odd years of its existence....

Unsuccessful in its attempts to secure administrative relief [with North Carolina], the Commission instituted this action challenging the constitutionality of the statute. [The] District Court found that the North Carolina statute, while neutral on its face, actually discriminated against Washington State growers and dealers in favor of their local counterparts [and] concluded that this discrimination [was] not justified by the asserted local interest—the elimination of deception and confusion from the marketplace—arguably furthered by the [statute].

...

[North Carolina] maintains that [the] burdens on the interstate sale of Washington apples were far outweighed by the local benefits flowing from what they contend was a valid exercise of North Carolina's [police powers]. Prior to the statute's enactment,...apples from 13 different States were shipped into North Carolina for sale. Seven of those States, including [Washington], had their own grading systems which, while differing in their standards, used similar descriptive labels (e.g., fancy, extra fancy, etc.). This multiplicity of inconsistent state grades [posed] dangers of deception and confusion not only in the North Carolina market, but in the Nation as a whole. The North Carolina statute, appellants claim, was enacted to eliminate this source of deception and confusion. [Moreover], it is contended that North Carolina sought to accomplish this goal of uniformity in an evenhanded manner as evidenced by the fact that its statute applies to all apples sold in closed containers in the State without regard to their point of origin.

[As] the appellants properly point out, not every exercise of state authority imposing some burden on the free flow of commerce is invalid, [especially] when the State acts to protect its citizenry in matters pertaining to the sale of foodstuffs. By the same token, however, a finding that state legislation furthers matters of legitimate local concern, even in the health and consumer protection areas, does not end the inquiry. Rather, when such state legislation comes into conflict with the Commerce Clause's overriding requirement of a national "common market," we are confronted with the task of effecting an accommodation of the competing national and local interests. We turn to that task.

As the District Court correctly found, the challenged statute has the practical effect of not only burdening interstate sales of Washington apples, but also discriminating against them. This discrimination takes various forms. The first, and most obvious, is the statute's consequence of raising *the costs* of doing business in the North Carolina market for Washington apple growers and dealers, while leaving those of their North Carolina counterparts unaffected. [This] disparate effect results from the fact that North Carolina apple producers, unlike their Washington competitors, were not forced to alter their marketing practices in order to comply with the statute. They were still free to market their wares under the USDA grade or none at all as they had done prior to the statute's enactment. Obviously, the increased costs imposed by the statute would tend to shield the local apple industry from the competition of Washington apple growers and dealers who are already at a competitive disadvantage because of their great distance from the North Carolina market.

Second, the statute has the effect of *stripping away* from the Washington apple industry the competitive and economic advantages it has earned for itself through its expensive inspection and grading system. The record demonstrates that the Washington apple-grading system has gained nationwide acceptance in the apple trade. [The record] contains numerous affidavits [stating a] preference [for] apples graded under the Washington, as opposed to the USDA, system because of the former's greater consistency, its emphasis on color, and its supporting mandatory inspections. Once again, the statute had no similar impact on the North Carolina apple industry and thus operated to its benefit.

Third, by *prohibiting* Washington growers and dealers from marketing apples under their State's grades, the statute has a *leveling effect* which insidiously operates to the advantage of local apple producers. [With] free market forces at work, Washington sellers would normally enjoy a distinct market advantage vis-à-vis local producers in those categories where the Washington grade is superior. However, because of the statute's operation, Washington apples which would otherwise qualify for and be sold under the superior Washington grades will now have to be marketed under their inferior USDA counterparts. Such "downgrading" offers the North Carolina apple industry the very sort of protection against competing out-of-state products that the Commerce Clause was designed to prohibit. At worst, it will have the effect of an embargo against those Washington apples in the superior grades as Washington dealers withhold them from the North Carolina market. At best, it will deprive Washington sellers of the market premium that such apples would otherwise command.

Despite the statute's facial neutrality, the Commission suggests that its discriminatory impact on interstate commerce was not an unintended by-product, and there are some indications in the record to that effect. The most glaring is the response of the North Carolina Agriculture Commissioner to the Commission's request for an exemption following the statute's passage

in which he indicated that before he could support such an exemption, he would "want to have the sentiment from our apple producers *since they were mainly responsible for* this *legislation being passed*." [Moreover], we find it somewhat suspect that North Carolina singled out only closed containers of apples, the very means by which apples are transported in commerce, to effectuate the statute's ostensible consumer protection purpose when apples are not generally sold at retail in their shipping containers. However, we need not ascribe an economic protection motive to the North Carolina Legislature to resolve this case; we conclude that the challenged statute cannot stand insofar as it prohibits the display of Washington State grades even if enacted for the declared purpose of protecting consumers from deception and fraud in the marketplace.

...

Finally, we note that any potential for confusion and deception created by the Washington grades was not of the type that led to the statute's enactment. Since Washington grades are in all cases equal or superior to their USDA counterparts, they could only "deceive" or "confuse" a consumer to his benefit, hardly a harmful result.

In addition, it appears that nondiscriminatory alternatives to the outright ban of Washington State grades are readily available. For example, North Carolina could effectuate its goal by permitting out-of-state growers to utilize state grades only if they also marked their shipments with the applicable USDA label. In that case, the USDA grade would serve as a benchmark against which the consumer could evaluate the quality of the various state grades....

[The court affirmed the lower court's holding that the North Carolina statute was unconstitutional.]

CASE QUESTIONS

1. Was the North Carolina law discriminatory on its face? Was it, possibly, an undue burden on interstate commerce? Why wouldn't it be?
2. What evidence was there of discriminatory intent behind the North Carolina law? Did that evidence even matter? Why or why not?

Citizens United v. Federal Election Commission

Citizens United v. Federal Election Commission

588 U.S. ___; 130 S.Ct. 876 (U.S. Supreme Court 2010)

Justice Kennedy delivered the opinion of the Court.

Federal law prohibits corporations and unions from using their general treasury funds to make independent expenditures for speech defined as an "electioneering communication" or for speech expressly advocating the election or defeat of a candidate. 2 U.S.C. §441b. Limits on electioneering communications were upheld in *McConnell v. Federal Election Comm'n*, 540 U.S. 93, 203–209 (2003). The holding of *McConnell* rested to a large extent on an earlier case, *Austin v. Michigan Chamber of Commerce*, 494 U.S. 652 (1990). *Austin* had held that political speech may be banned based on the speaker's corporate identity.

In this case we are asked to reconsider *Austin* and, in effect, *McConnell*. It has been noted that "*Austin* was a significant departure from ancient First Amendment principles," *Federal Election Comm'n v. Wisconsin Right to Life, Inc.*, 551 U.S. 449, 490 (2007) (*WRTL*) (Scalia, J., concurring in part and concurring in judgment). We agree with that conclusion and hold that *stare decisis* does not compel the continued acceptance of *Austin*. The Government may regulate corporate political speech through disclaimer and disclosure requirements, but it may not suppress that speech altogether. We turn to the case now before us.

I

A

Citizens United is a nonprofit corporation. It has an annual budget of about $12 million. Most of its funds are from donations by individuals; but, in addition, it accepts a small portion of its funds from for-profit corporations.

In January 2008, Citizens United released a film entitled *Hillary: The Movie*. We refer to the film as *Hillary*. It is a 90-minute

documentary about then-Senator Hillary Clinton, who was a candidate in the Democratic Party's 2008 Presidential primary elections. *Hillary* mentions Senator Clinton by name and depicts interviews with political commentators and other persons, most of them quite critical of Senator Clinton....

In December 2007, a cable company offered, for a payment of $1.2 million, to make *Hillary* available on a video-on-demand channel called "Elections '08."...Citizens United was prepared to pay for the video-on-demand; and to promote the film, it produced two 10-second ads and one 30-second ad for *Hillary*. Each ad includes a short (and, in our view, pejorative) statement about Senator Clinton, followed by the name of the movie and the movie's Website address. Citizens United desired to promote the video-on-demand offering by running advertisements on broadcast and cable television.

B

Before the Bipartisan Campaign Reform Act of 2002 (BCRA), federal law prohibited—and still does prohibit—corporations and unions from using general treasury funds to make direct contributions to candidates or independent expenditures that expressly advocate the election or defeat of a candidate, through any form of media, in connection with certain qualified federal elections....BCRA §203 amended §441b to prohibit any "electioneering communication" as well. An electioneering communication is defined as "any broadcast, cable, or satellite communication" that "refers to a clearly identified candidate for Federal office" and is made within 30 days of a primary or 60 days of a general election. §434(f)(3)(A). The Federal Election Commission's (FEC) regulations further define an electioneering communication as a communication that is "publicly distributed." 11 CFR §100.29(a)(2) (2009). "In the case of a candidate for nomination for President...*publicly distributed* means" that the communication "[c]an be received by 50,000 or more persons in a State where a primary election...is being held within 30 days." 11 CFR §100.29(b)(3)(ii). Corporations and unions are barred from using their general treasury funds for express advocacy or electioneering communications. They may establish, however, a "separate segregated fund" (known as a political action committee, or PAC) for these purposes. 2 U.S.C. §441b(b)(2). The moneys received by the segregated fund are limited to donations from stockholders and employees of the corporation or, in the case of unions, members of the union. *Ibid*.

C

Citizens United wanted to make *Hillary* available through video-on-demand within 30 days of the 2008 primary elections. It feared, however, that both the film and the ads would be covered by §441b's ban on corporate-funded independent expenditures, thus subjecting the corporation to civil and criminal penalties under §437g. In December 2007, Citizens United sought declaratory and injunctive relief against the FEC. It argued that (1) §441b is unconstitutional as applied to *Hillary*; and (2) BCRA's disclaimer and disclosure requirements, BCRA §§201 and 311, are unconstitutional as applied to *Hillary* and to the three ads for the movie.

The District Court denied Citizens United's motion for a preliminary injunction, and then granted the FEC's motion for summary judgment.

...

The court held that §441b was facially constitutional under *McConnell*, and that §441b was constitutional as applied to *Hillary* because it was "susceptible of no other interpretation than to inform the electorate that Senator Clinton is unfit for office, that the United States would be a dangerous place in a President Hillary Clinton world, and that viewers should vote against her." 530 F. Supp. 2d, at 279. The court also rejected Citizens United's challenge to BCRA's disclaimer and disclosure requirements. It noted that "the Supreme Court has written approvingly of disclosure provisions triggered by political speech even though the speech itself was constitutionally protected under the First Amendment." *Id.* at 281.

II

[Omitted: the court considers whether it is possible to reject the BCRA without declaring certain provisions unconstitutional. The court concludes it cannot find a basis to reject the BCRA that does not involve constitutional issues.]

III

The First Amendment provides that "Congress shall make no law...abridging the freedom of speech." Laws enacted to control or

suppress speech may operate at different points in the speech process....The law before us is an outright ban, backed by criminal sanctions. Section 441b makes it a felony for all corporations—including nonprofit advocacy corporations—either to expressly advocate the election or defeat of candidates or to broadcast electioneering communications within 30 days of a primary election and 60 days of a general election. Thus, the following acts would all be felonies under §441b: The Sierra Club runs an ad, within the crucial phase of 60 days before the general election, that exhorts the public to disapprove of a Congressman who favors logging in national forests; the National Rifle Association publishes a book urging the public to vote for the challenger because the incumbent U.S. Senator supports a handgun ban; and the American Civil Liberties Union creates a Web site telling the public to vote for a Presidential candidate in light of that candidate's defense of free speech. These prohibitions are classic examples of censorship.

Section 441b is a ban on corporate speech notwithstanding the fact that a PAC created by a corporation can still speak. PACs are burdensome alternatives; they are expensive to administer and subject to extensive regulations. For example, every PAC must appoint a treasurer, forward donations to the treasurer promptly, keep detailed records of the identities of the persons making donations, preserve receipts for three years, and file an organization statement and report changes to this information within 10 days.

And that is just the beginning. PACs must file detailed monthly reports with the FEC, which are due at different times depending on the type of election that is about to occur....

PACs have to comply with these regulations just to speak. This might explain why fewer than 2,000 of the millions of corporations in this country have PACs. PACs, furthermore, must exist before they can speak. Given the onerous restrictions, a corporation may not be able to establish a PAC in time to make its views known regarding candidates and issues in a current campaign.

Section 441b's prohibition on corporate independent expenditures is thus a ban on speech. As a "restriction on the amount of money a person or group can spend on political communication during a campaign," that statute "necessarily reduces the quantity of expression by restricting the number of issues discussed, the depth of their exploration, and the size of the audience reached." *Buckley v. Valeo*, 424 U.S. 1 at 19 (1976)....

Speech is an essential mechanism of democracy, for it is the means to hold officials accountable to the people. See *Buckley*, *supra*, at 14–15 ("In a republic where the people are sovereign, the ability of the citizenry to make informed choices among candidates for office is essential.") The right of citizens to inquire, to hear, to speak, and to use information to reach consensus is a precondition to enlightened self-government and a necessary means to protect it. The First Amendment "'has its fullest and most urgent application' to speech uttered during a campaign for political office."

For these reasons, political speech must prevail against laws that would suppress it, whether by design or inadvertence. Laws that burden political speech are "subject to strict scrutiny," which requires the Government to prove that the restriction "furthers a compelling interest and is narrowly tailored to achieve that interest."

...

The Court has recognized that First Amendment protection extends to corporations. This protection has been extended by explicit holdings to the context of political speech. Under the rationale of these precedents, political speech does not lose First Amendment protection "simply because its source is a corporation." *Bellotti*, *supra*, at 784. The Court has thus rejected the argument that political speech of corporations or other associations should be treated differently under the First Amendment simply because such associations are not "natural persons."

The purpose and effect of this law is to prevent corporations, including small and nonprofit corporations, from presenting both facts and opinions to the public. This makes *Austin*'s antidistortion rationale all the more an aberration. "[T]he First Amendment protects the right of corporations to petition legislative and administrative bodies." *Bellotti*, 435 U.S., at 792, n. 31....

Even if §441b's expenditure ban were constitutional, wealthy corporations could still lobby elected officials, although smaller corporations may not have the resources to do so. And wealthy individuals and unincorporated associations can spend unlimited amounts on independent expenditures. See, e.g., *WRTL*, 551 U.S., at 503–504 (opinion of Scalia, J.) ("In the 2004 election cycle, a mere 24 individuals contributed an astounding total of $142 million to [26 U.S.C. §527 organizations]"). Yet certain disfavored associations of citizens—those that have taken on the corporate form—are penalized for engaging in the same political speech.

When Government seeks to use its full power, including the criminal law, to command where a person may get his or her information or what distrusted source he or she may not hear, it uses censorship to control thought. This is unlawful. The First Amendment confirms the freedom to think for ourselves.

What we have said also shows the invalidity of other arguments made by the Government. For the most part relinquishing the anti-distortion rationale, the Government falls back on the argument that corporate political speech can be banned in order to prevent corruption or its appearance....

When Congress finds that a problem exists, we must give that finding due deference; but Congress may not choose an unconstitutional remedy. If elected officials succumb to improper influences from independent expenditures; if they surrender their best judgment; and if they put expediency before principle, then surely there is cause for concern. We must give weight to attempts by Congress to seek to dispel either the appearance or the reality of these influences. The remedies enacted by law, however, must comply with the First Amendment; and, it is our law and our tradition that more speech, not less, is the governing rule. An outright ban on corporate political speech during the critical preelection period is not a permissible remedy. Here Congress has created categorical bans on speech that are asymmetrical to preventing *quid pro quo* corruption.

Our precedent is to be respected unless the most convincing of reasons demonstrates that adherence to it puts us on a course that is sure error. "Beyond workability, the relevant factors in deciding whether to adhere to the principle of *stare decisis* include the antiquity of the precedent, the reliance interests at stake, and of course whether the decision was well reasoned." [citing prior cases]

These considerations counsel in favor of rejecting *Austin*, which itself contravened this Court's earlier precedents in *Buckley* and *Bellotti*. "This Court has not hesitated to overrule decisions offensive to the First Amendment." *WRTL*, 551 U.S., at 500 (opinion of Scalia, J.). "*[S]tare decisis* is a principle of policy and not a mechanical formula of adherence to the latest decision." *Helvering* v. *Hallock*, 309 U.S. 106 at 119 (1940).

Austin is undermined by experience since its announcement. Political speech is so ingrained in our culture that speakers find ways to circumvent campaign finance laws. See, *e.g.*, *McConnell*, 540 U.S., at 176–177 ("Given BCRA's tighter restrictions on the raising and spending of soft money, the incentives...to exploit [26 U.S.C. §527] organizations will only increase"). Our Nation's speech dynamic is changing, and informative voices should not have to circumvent onerous restrictions to exercise their First Amendment rights. Speakers have become adept at presenting citizens with sound bites, talking points, and scripted messages that dominate the 24-hour news cycle. Corporations, like individuals, do not have monolithic views. On certain topics corporations may possess valuable expertise, leaving them the best equipped to point out errors or fallacies in speech of all sorts, including the speech of candidates and elected officials.

Rapid changes in technology—and the creative dynamic inherent in the concept of free expression—counsel against upholding a law that restricts political speech in certain media or by certain speakers. Today, 30-second television ads may be the most effective way to convey a political message. Soon, however, it may be that Internet sources, such as blogs and social networking Web sites, will provide citizens with significant information about political candidates and issues. Yet, §441b would seem to ban a blog post expressly advocating the election or defeat of a candidate if that blog were created with corporate funds. The First Amendment does not permit Congress to make these categorical distinctions based on the corporate identity of the speaker and the content of the political speech.

Due consideration leads to this conclusion: *Austin* should be and now is overruled. We return to the principle established in *Buckley* and *Bellotti* that the Government may not suppress political speech on the basis of the speaker's corporate identity. No sufficient governmental interest justifies limits on the political speech of nonprofit or for-profit corporations.

[IV. Omitted]

V

When word concerning the plot of the movie *Mr. Smith Goes to Washington* reached the circles of Government, some officials sought, by persuasion, to discourage its distribution. See Smoodin, "Compulsory" Viewing for Every Citizen: *Mr. Smith* and the Rhetoric of Reception, 35 Cinema Journal 3, 19, and n. 52 (Winter 1996) (citing Mr. Smith Riles Washington, Time, Oct. 30, 1939, p. 49); Nugent, Capra's Capitol Offense, N. Y. Times, Oct. 29, 1939, p. X5. Under *Austin*, though, officials could have done more than discourage its distribution—they could have banned the film. After all, it, like *Hillary,* was speech funded by a corporation that was critical of Members of Congress. *Mr. Smith Goes to Washington* may be fiction and caricature; but fiction and caricature can be a powerful force.

Modern day movies, television comedies, or skits on YouTube.com might portray public officials or public policies in unflattering ways. Yet if a covered transmission during the blackout period creates the background for candidate endorsement or opposition,

a felony occurs solely because a corporation, other than an exempt media corporation, has made the "purchase, payment, distribution, loan, advance, deposit, or gift of money or anything of value" in order to engage in political speech. 2 U.S.C. §431(9)(A)(i). Speech would be suppressed in the realm where its necessity is most evident: in the public dialogue preceding a real election. Governments are often hostile to speech, but under our law and our tradition it seems stranger than fiction for our Government to make this political speech a crime. Yet this is the statute's purpose and design.

Some members of the public might consider *Hillary* to be insightful and instructive; some might find it to be neither high art nor a fair discussion on how to set the Nation's course; still others simply might suspend judgment on these points but decide to think more about issues and candidates. Those choices and assessments, however, are not for the Government to make. "The First Amendment underwrites the freedom to experiment and to create in the realm of thought and speech. Citizens must be free to use new forms, and new forums, for the expression of ideas. The civic discourse belongs to the people, and the Government may not prescribe the means used to conduct it." *McConnell*, *supra*, at 341 (opinion of Kennedy, J.).

The judgment of the District Court is reversed with respect to the constitutionality of 2 U.S.C. §441b's restrictions on corporate independent expenditures. The case is remanded for further proceedings consistent with this opinion.

It is so ordered.

CASE QUESTIONS

1. What does the case say about disclosure? Corporations have a right of free speech under the First Amendment and may exercise that right through unrestricted contributions of money to political parties and candidates. Can the government condition that right by requiring that the parties and candidates disclose to the public the amount and origin of the contribution? What would justify such a disclosure requirement?
2. Are a corporation's contributions to political parties and candidates tax deductible as a business expense? Should they be?
3. How is the donation of money equivalent to speech? Is this a strict construction of the Constitution to hold that it is?
4. Based on the Court's description of the *Austin* case, what purpose do you think the *Austin* court was trying to achieve by limiting corporate campaign contributions? Was that purpose consistent (or inconsistent) with anything in the Constitution, or is the Constitution essentially silent on this issue?

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4.7: Summary and Exercises

Summary

The US. Constitution sets the framework for all other laws of the United States, at both the federal and the state level. It creates a shared balance of power between states and the federal government (federalism) and shared power among the branches of government (separation of powers), establishes individual rights against governmental action (Bill of Rights), and provides for federal oversight of matters affecting interstate commerce and commerce with foreign nations. Knowing the contours of the US legal system is not possible without understanding the role of the US Constitution.

The Constitution is difficult to amend. Thus when the Supreme Court uses its power of judicial review to determine that a law is unconstitutional, it actually shapes what the Constitution means. New meanings that emerge must do so by the process of amendment or by the passage of time and new appointments to the court. Because justices serve for life, the court changes its philosophical outlook slowly.

The Bill of Rights is an especially important piece of the Constitutional framework. It provides legal causes of action for infringements of individual rights by government, state or federal. Through the due process clause of the Fifth Amendment and the Fourteenth Amendment, both procedural and (to some extent) substantive due process rights are given to individuals.

EXERCISES

1. For many years, the Supreme Court believed that “commercial speech” was entitled to less protection than other forms of speech. One defining element of commercial speech is that its dominant theme is to propose a commercial transaction. This kind of speech is protected by the First Amendment, but the government is permitted to regulate it more closely than other forms of speech. However, the government must make reasonable distinctions, must narrowly tailor the rules restricting commercial speech, and must show that government has a legitimate goal that the law furthers.

   Edward Salib owned a Winchell’s Donut House in Mesa, Arizona. To attract customers, he displayed large signs in store windows. The city ordered him to remove the signs because they violated the city’s sign code, which prohibited covering more than 30 percent of a store’s windows with signs. Salib sued, claiming that the sign code violated his First Amendment rights. What was the result, and why?

2. Jennifer is a freshman at her local public high school. Her sister, Jackie, attends a nearby private high school. Neither school allows them to join its respective wrestling team; only boys can wrestle at either school. Do either of them have a winning case based on the equal protection clause of the Fourteenth Amendment?
3. The employees of the US Treasury Department that work the border crossing between the United States and Mexico learned that they will be subject to routine drug testing. The customs bureau, which is a division of the treasury department, announces this policy along with its reasoning: since customs agents must routinely search for drugs coming into the United States, it makes sense that border guards must themselves be completely drug-free. Many border guards do not use drugs, have no intention of using drugs, and object to the invasion of their privacy. What is the constitutional basis for their objection?
4. Happy Time Chevrolet employs Jim Bydalek as a salesman. Bydalek takes part in a Gay Pride March in Los Angeles, is interviewed by a local news camera crew, and reports that he is gay and proud of it. His employer is not, and he is fired. Does he have any constitutional causes of action against his employer?
5. You begin work at the Happy-Go-Lucky Corporation on Halloween. On your second day at work, you wear a political button on your coat, supporting your choice for US senator in the upcoming election. Your boss, who is of a different political persuasion, looks at the button and says, “Take that stupid button off or you’re fired.” Has your boss violated your constitutional rights?
6. David Lucas paid $975,000 for two residential parcels on the Isle of Palms near Charleston, South Carolina. His intention was to build houses on them. Two years later, the South Carolina legislature passed a statute that prohibited building beachfront properties. The purpose was to leave the dunes system in place to mitigate the effects of hurricanes and strong storms. The South Carolina Coastal Commission created the rules and regulations with substantial input from the community and from experts and with protection of the dune system primarily in mind. People had been building on the shoreline for years, with harmful results to localities and the state treasury. When Lucas applied for permits to build two houses near the shoreline, his

permits were rejected. He sued, arguing that the South Carolina legislation had effectively "taken" his property. At trial, South Carolina conceded that because of the legislation, Lucas's property was effectively worth zero. Has there been a taking under the Fifth Amendment (as incorporated through the Fourteenth Amendment), and if so, what should the state owe to Lucas? Suppose that Lucas could have made an additional $1 million by building a house on each of his parcels. Is he entitled to recover his original purchase price or his potential profits?

SELF-TEST QUESTIONS

1. Harvey filed a suit against the state of Colorado, claiming that a Colorado state law violates the commerce clause. The court will agree if the statute
    1. places an undue burden on interstate commerce
    2. promotes the public health, safety, morals, or general welfare of Colorado
    3. regulates economic activities within the state's borders
    4. a and b
    5. b and c
2. The state legislature in Maine enacts a law that directly conflicts with a federal law. Mapco Industries, located in Portland, Maine, cannot comply with both the state and the federal law.
    1. Because of federalism, the state law will have priority, as long as Maine is using its police powers.
    2. Because there's a conflict, both laws are invalid; the state and the federal government will have to work out a compromise of some sort.
    3. The federal law preempts the state law.
    4. Both laws govern concurrently.
3. Hannah, who lives in Ada, is the owner of Superior Enterprises, Inc. She believes that certain actions in the state of Ohio infringe on her federal constitutional rights, especially those found in the Bill of Rights. Most of these rights apply to the states under
    1. the supremacy clause
    2. the protection clause
    3. the due process clause of the Fourteenth Amendment
    4. the Tenth Amendment
4. Minnesota enacts a statute that bans all advertising that is in "bad taste," "vulgar," or "indecent." In Michigan, Aaron Calloway and his brother, Clarence "Cab" Calloway, create unique beer that they decide to call Old Fart Ale. In their marketing, the brothers have a label in which an older man in a dirty T-shirt is sitting in easy chair, looking disheveled and having a three-day growth of stubble on his chin. It appears that the man is in the process of belching. He is also holding a can of Old Fart Ale. The Minnesota liquor commission orders all Minnesota restaurants, bars, and grocery stores to remove Old Fart Ale from their shelves. The state statute and the commission's order are likely to be held by a court to be
    1. a violation of the Tenth Amendment
    2. a violation of the First Amendment
    3. a violation of the Calloways' right to equal protection of the laws
    4. a violation of the commerce clause, since only the federal laws can prevent an article of commerce from entering into Minnesota's market
5. Raunch Unlimited, a Virginia partnership, sells smut whenever and wherever it can. Some of its material is "obscene" (meeting the Supreme Court's definition under *Miller v. California*) and includes child pornography. North Carolina has a statute that criminalizes obscenity. What are possible results if a store in Raleigh, North Carolina, carries Raunch merchandise?
    1. The partners could be arrested in North Carolina and may well be convicted.
    2. The materials in Raleigh may be the basis for a criminal conviction.
    3. The materials are protected under the First Amendment's right of free speech.
    4. The materials are protected under state law.
    5. a and b

SELF-TEST AnswerS

1. a
2. c
3. c
4. b
5. e

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5: CRIMINAL LAW

Learning Objectives

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

1. Explain how criminal law differs from civil law.
2. Categorize the various types of crimes and define the most serious felonies.
3. Discuss and question the criminal “intent” of a corporation.
4. Explain basic criminal procedure and the rights of criminal defendants.

At times, unethical behavior by businesspeople can be extreme enough that society will respond by criminalizing certain kinds of activities. Ponzi schemes, arson, various kinds of fraud, embezzlement, racketeering, foreign corrupt practices, tax evasion, and insider trading are just a few. A corporation can face large fines, and corporate managers can face both fines and jail sentences for violating criminal laws. This chapter aims to explain how criminal law differs from civil law, to discuss various types of crimes, and to relate the basic principles of criminal procedure.

5.1: The Nature of Criminal Law

5.2: Types of Crimes

5.3: The Nature of a Criminal Act

5.4: Procedure

5.5: Constitutional Rights of the Accused

5.6: Cases

5.7: Summary and Exercises

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5.1: The Nature of Criminal Law

Introduction to Criminal Law

Criminal law is the oldest and most fundamental branch of law. Unlike civil law, which primarily resolves disputes between individuals or organizations, criminal law is concerned with offenses against society as a whole. Even when a crime appears to involve only two people—for example, a bar fight or a theft from a single store—the state prosecutes the offense on behalf of society because it is believed that the act undermines public order and safety.

Crimes vs. Civil Wrongs

- **Civil wrongs (torts or contract breaches):** Focus on compensating the injured party. For example, if you hit someone's car, they may sue you for the cost of repairs.
- **Crimes:** Focus on punishing conduct harmful to society. For example, driving drunk may cause no accident but is still prosecuted as a crime because of the risk it poses to the community.

Example: Two friends get into a fight outside a party. One suffers a bloody nose but later reconciles with the other. Even if the victim decides not to sue for damages, the state can still prosecute for *assault and battery*, because society has an interest in discouraging violence.

Who Defines Crimes?

Crimes are generally defined by legislatures in **statutes**. Legislatures describe in broad terms what conduct is criminal and assign possible punishments. Because punishment is serious—fines, imprisonment, or even death—laws must provide clear notice of prohibited conduct.

- **Ex Post Facto Laws:** The U.S. Constitution prohibits laws passed "after the fact" that punish conduct that was legal when committed.
  - *Example:* If a state passed a law today criminalizing texting while walking, it could not punish someone for texting while walking last week.
- **Void for Vagueness Doctrine:** Courts may strike down laws that are too vague for the average person to understand.
  - *Example:* Old "vagrancy" laws that punished being a "suspicious person" were struck down because people could not reasonably know what behavior was forbidden.

Changing Definitions of Crime

What counts as "criminal" changes over time and across societies.

- **Drugs:** Cocaine was once legal in the U.S. but is now a controlled substance. Marijuana possession was a felony in many states 50 years ago; today, some states allow recreational use.
- **Speech:** In the U.S., criticizing the president is protected by the First Amendment. In other countries, insulting political leaders is a crime.
- **Morality:** Homosexuality is criminalized in places like Uganda, with extremely harsh penalties, while in the U.S. such laws have been struck down as unconstitutional.

Limits on Punishment

The **Eighth Amendment** to the U.S. Constitution prohibits "cruel and unusual punishments." This protects against extreme penalties.

- *Example:* In the U.S., the death penalty is permitted in certain cases, but methods of execution and its application to minors or the mentally disabled have been limited by the Supreme Court.
- *Example abroad:* Saudi Arabia has proposed punishments such as paralyzing offenders who paralyzed victims. Such punishments would not be constitutional in the U.S.

Ignorance of the Law

The common saying, *"ignorance of the law is no excuse,"* reflects society's view that citizens are bound by laws whether they know them or not.

- *Example:* Failing to wear a seatbelt may feel like a "victimless" choice, but lawmakers argue that severe injuries create social costs—such as taxpayer-funded hospital care—justifying criminalization.

Elements of a Crime

To convict someone, prosecutors generally must prove **two elements**:

1. **Actus Reus ("guilty act"):** The physical act or conduct prohibited by law.
2. **Mens Rea ("guilty mind"):** The intent or mental state behind the act.

- **Example – No Actus Reus:** A person who fantasizes about committing a robbery but never takes action has no crime, even if he has criminal intent.
- **Example – No Mens Rea:** A person forced at gunpoint to rob a store commits the act (actus reus) but lacks intent (mens rea) and is not guilty.

Crimes as Offenses Against Society

Once an act is defined as a crime, private agreements between the victim and the offender cannot prevent prosecution.

- *Example:* If someone is assaulted in a bar fight, the victim may forgive the offender and refuse to sue, but the prosecutor can still bring criminal charges.
- *Note:* Practical realities (such as crowded dockets or uncooperative victims) may lead prosecutors to decline cases, but the choice is the state's, not the victim's.

KEY TAKEAWAY

Criminal law defines certain acts as offenses against society, not just individual victims. To establish guilt, there must be both a prohibited act (**actus reus**) and criminal intent (**mens rea**). Laws must be clear and provide notice, and punishments are limited by constitutional protections.

EXERCISES

1. Other than deterring certain kinds of conduct, what purpose does the criminal law serve?
2. Why is ignorance of the law no excuse? Why shouldn't it be an excuse, when criminal laws can be complicated and sometimes ambiguous?

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5.2: Types of Crimes

LEARNING OBJECTIVES

1. Explain how mens rea, or the “guilty mind,” shapes criminal responsibility
2. Categorize various types of crimes.
3. Name and define the major felonies in criminal law.
4. Explain how white-collar crime differs from other crimes.
5. Define a variety of white-collar crimes.

In General: Mens Rea

The **mens rea** (or “guilty mind”) requirement depends on the type of crime and the circumstances surrounding the act. In general, it means that the accused must, in some way, have intended the criminal consequences of his actions. Courts distinguish carefully between intentional acts, reckless acts, negligent acts, and acts where no mental state is required at all.

- **Example – Intent to Kill:**
  Charlie gives Gabrielle a poison capsule to swallow. If he gave it to her **intending to kill**, this is clearly **murder**.

- **Example – Knowledge of Risk:**
  If Charlie knew the capsule was poison but believed it would only make Gabrielle mildly ill, it is still murder. Why? Because the law holds us liable for the natural and foreseeable consequences of intentionally harmful acts.

- **Example – Lack of Knowledge:**
  Suppose Gabrielle asked Harry for aspirin, and he handed her two pills he **reasonably believed** were aspirin (they came from a properly labeled bottle and looked like aspirin), but the pills turned out to be poison. Gabrielle dies, but Harry had no intent or knowledge from which intent could be inferred. This would not be murder—though it might raise other issues depending on the circumstances (such as negligence, if Harry ignored obvious warning signs).

Crimes Without Mens Rea

Not every criminal law requires proof of intent. Many modern statutes, especially those regulating **public health, safety, and welfare**, impose liability regardless of state of mind. These are called **strict liability crimes**.

- **Example – Food and Drug Violations:**
  A company president may be held criminally liable for selling contaminated food, even if he did not know about the contamination.

- **United States v. Park (1975):**
  In this case, the Supreme Court upheld the conviction of a corporate executive for violations of the Federal Food, Drug, and Cosmetic Act when rodents were found contaminating food warehouses. Even though Park had **no direct knowledge** of the violations, the Court held him criminally responsible as a “responsible corporate officer” because he was in a position to prevent or correct the violation.

Classifications of Crime

When we think about crime, not all offenses carry the same weight in the eyes of the law. Some acts are considered extremely serious, such as murder or armed robbery, while others—like petty theft or a traffic violation—are viewed as less severe. Legislatures and courts classify crimes along a spectrum of seriousness, and this classification influences everything from the way cases are prosecuted to the potential punishments imposed.

At the most serious end are crimes that society views as especially dangerous or harmful, often involving violence, large-scale

fraud, or threats to public safety. These cases typically lead to long prison sentences or other life-altering consequences. At the opposite end are minor offenses, often called “petty” or “minor” violations, which may result only in fines or warnings. In between are the wide range of everyday cases—assaults, thefts, property damage—that still matter greatly to the individuals involved and to society but do not usually carry the harshest punishments.

Crimes can also be understood in terms of the kind of harm they cause. Some target individuals directly, such as assault or kidnapping. Others focus on property, such as theft, burglary, or arson. Still others involve dishonest or deceptive practices in business and finance, often called “white-collar crimes.” Finally, certain offenses are aimed at preserving the broader fabric of public order—acts like gambling violations, drug possession, or disorderly conduct.

The key point is that criminal law organizes offenses in a way that reflects both the seriousness of the act and the kind of social harm it causes. These categories not only affect punishments but also shape how law enforcement, prosecutors, and judges approach each case.

Offenses against the Person

Homicide

Homicide is the killing of one person by another. While the word itself is neutral, the law distinguishes between killings that are legally justified or excused and those that are punishable as crimes.

Justifiable and Excusable Homicide

Not every killing is criminal. Some deaths are **justifiable**—for example, a soldier killing an enemy in wartime or a homeowner acting in lawful self-defense when faced with an armed intruder. Other killings are **excusable**, meaning they result from accidents where the killer is not at fault. For instance, if a driver who is following all traffic laws hits a pedestrian who darts unexpectedly into traffic, the death may be excusable.

Criminal Homicide

When a killing cannot be justified or excused, it becomes a **criminal homicide**. Criminal homicide takes different forms depending on the killer’s state of mind and the circumstances.

First-Degree Murder

The most serious offense is **first-degree murder**—an unlawful killing that is both intentional and premeditated. Premeditation does not require weeks of planning; it can occur moments before the act, as long as the killer formed the conscious intent to take a life. An example would be someone lying in wait to ambush a rival or calmly retrieving a weapon before shooting.

Second-Degree Murder

Second-degree murder is an intentional killing that lacks premeditation or that results from extremely reckless conduct showing “depraved indifference” to human life. For example, firing a gun into a crowded room without aiming at anyone in particular could qualify.

Felony Murder Rule

Under the **felony murder rule**, a killing that occurs during the commission or attempted commission of certain dangerous felonies (such as armed robbery, arson, burglary, rape, or kidnapping) is automatically considered murder, regardless of intent. Importantly, all participants in the felony can be held liable.

- Example: During an armed robbery, a store clerk suffers a fatal heart attack from the stress. Even if the robbers did not intend to cause death, they may be charged with felony murder.
- Example: If an arsonist sets fire to a building and a firefighter dies of smoke inhalation while responding, the arsonist can be

charged with murder.
- Example: A getaway driver who never enters the store during a robbery can still be convicted of murder if an accomplice inside kills someone.

Manslaughter

Not all unlawful killings are treated as murder. When malice aforethought is absent, the offense may be **manslaughter**.

- **Voluntary manslaughter** is an intentional killing carried out in the "heat of passion" after being provoked. A classic example is discovering a spouse in an affair and reacting violently in the moment.
- **Involuntary manslaughter** involves reckless or negligent conduct that unintentionally results in death. A common scenario is a fatal car accident caused by drunk driving or by running a red light.

Homicide Defenses

Not every killing that results in death is legally punishable. The law recognizes that there are situations in which taking another person's life may be excused, justified, or reduced to a lesser offense. The most common defenses to homicide charges include **self-defense, defense of others, defense of habitation, insanity, diminished capacity, intoxication, accident, and necessity/duress.**

Self-Defense

- A defendant may use deadly force if they reasonably believe it is necessary to prevent imminent death or great bodily harm.
- The force used must be **proportional** to the threat. Deadly force cannot be used to repel non-deadly force.
- **Example:** If someone points a loaded gun at you, and you shoot first to protect yourself, the killing may be justified.
- **Limits:** Some jurisdictions require a duty to retreat if safe to do so, unless the defendant is in their own home (the "castle doctrine").
- **Case Example:** *People v. Goetz* (N.Y. 1986) – a man shot four youths he believed were about to rob him on a subway. The court focused on whether his belief in the need for deadly force was "reasonable."

Defense of Others

- A person may use force, including deadly force, if they reasonably believe it necessary to defend another person from imminent unlawful harm.
- **Example:** Seeing someone attacked with a knife, you intervene with deadly force to save them.

Defense of Habitation (Castle Doctrine and Stand Your Ground)

- Many states allow the use of deadly force to prevent an unlawful intruder from entering one's home.
- **Example:** A homeowner shoots an armed burglar breaking into the house at night.
- **Modern Variations:** Some states expand this to cars or workplaces. "Stand your ground" laws (like in Florida) go further, removing the duty to retreat in public places if threatened.

Insanity

- If, at the time of the act, the defendant was legally insane, they may be excused.
- Tests for insanity include:
  - **M'Naghten Rule:** Did the defendant know the nature of the act or that it was wrong?
  - **Irresistible Impulse Test:** Did a mental disease prevent the defendant from controlling their actions?
  - **Model Penal Code Test:** Did the defendant lack substantial capacity to appreciate the criminality of the conduct or conform conduct to the law?
- **Example:** A person with schizophrenia kills under a delusion that the victim was a demon.

Diminished Capacity

- Not a full defense but may reduce murder to manslaughter if the defendant could not form the specific intent required for murder.
- **Example:** An individual suffering from severe depression kills but demonstrates they could not premeditate or form malice aforethought.

Intoxication

- **Voluntary intoxication** generally is not a defense but may negate the specific intent required for certain homicide charges (e.g., first-degree murder).
- **Involuntary intoxication** (e.g., being drugged without knowledge) may serve as a complete defense.
- **Example:** A person unknowingly given a hallucinogen kills while under its effects; if they could not form intent, liability may be reduced.

Accident

- A killing that occurs without intent, recklessness, or criminal negligence may be excusable.
- **Example:** A hunter accidentally fires at what he thought was a deer but turns out to be another hunter, with no negligence involved.

Necessity and Duress

- **Necessity:** The defendant kills to prevent a greater harm.
  - **Example:** A driver swerves to avoid hitting a crowd of people but kills one pedestrian instead.
- **Duress:** The defendant is forced to commit homicide under threat of imminent death or serious injury.
  - **Limitation:** Traditionally, duress is not a defense to intentional killing, though it may mitigate liability.

Assault and Battery

Assault and battery appear in both **criminal law** and **tort law**. In criminal law, they are prosecuted by the state because they involve harm to society and public order. But they are also recognized as torts—civil wrongs—because they involve direct harm to individuals. A criminal conviction for battery might result in jail time or fines, while a civil lawsuit for the same act could result in monetary damages paid to the victim. For example, someone who punches another person in a bar fight could be prosecuted by the state for battery **and** sued in civil court by the victim for medical expenses and pain and suffering. This dual nature highlights how assault and battery cross the boundary between protecting society as a whole and protecting the rights of individual victims.

Battery

Battery is the unlawful application of force to another person. The force need not be violent—any offensive or unwanted physical contact can qualify.

- **Examples of Battery**:
  - A man kisses a woman against her will.
  - A surgeon operates without the patient's consent (hence the importance of consent forms).
  - Athletes in contact sports consent to physical play within the rules, but a hockey player who smashes an opponent with a stick outside the rules may be guilty of battery.

Consent is central: when a person agrees to the contact (e.g., surgery, football tackles), it is not a crime.

Assault

Assault can occur in two main ways:

1. An **attempt to commit a battery** (swinging a fist but missing).
2. An **intentional act that puts another in fear of immediate harm**, even without physical contact.

- **Examples of Assault**:
  - Throwing a rock at someone but missing.
  - Raising a fist as if about to strike.
  - Pointing an unloaded gun at someone—the victim's fear may be reasonable even if the gun cannot fire.

Some states require a "present ability" to cause harm, while others only require that the victim reasonably believed harm was imminent.

Excuses and Defenses

Certain uses of force are legally excused:

- **Self-Defense**: Reasonable force may be used to repel an attack.
- **Defense of Property**: Limited force may be used to prevent theft.
- **Maintaining Order**: A bar owner or bouncer may eject an unruly patron, but excessive force could result in both criminal charges and a civil lawsuit.

Offenses against Property

Theft: Larceny, Robbery, Embezzlement, False Pretenses

Theft, broadly defined, is the unlawful taking of another's property with the intent to permanently deprive the owner of it. While all theft-related crimes involve dishonesty and the taking of property, the law distinguishes among several categories, each with its own specific elements. Understanding these distinctions is essential, since the charge and potential punishment depend on the circumstances of the taking.

Larceny

Definition: The trespassory (without consent) taking and carrying away of personal property belonging to another with the intent to permanently deprive the owner of it.

Elements:

1. Trespassory taking (without consent).
2. Carrying away (asportation—even slight movement counts).
3. Personal property of another.
4. Intent to permanently deprive the owner.

Examples:

- A shoplifter slips a necklace into her pocket and walks out of a store.
- A person takes a neighbor's lawnmower without permission, intending never to return it.

Defenses:

- **Lack of Intent:** The defendant intended only to borrow the property, not to permanently keep it.
  - *Example:* Borrowing a neighbor's lawnmower intending to return it.
- **Consent:** If the owner consented to the taking, no larceny occurs.
  - *Example:* A store clerk allows a customer to "test" merchandise outside but later accuses them of theft.
- **Mistake of Fact:** The defendant believed the property was theirs.

- *Example:* Taking the wrong umbrella from a restaurant stand, genuinely thinking it was your own.

Robbery

Definition: A larceny accomplished by force, intimidation, or threat of violence. Robbery is considered a more serious crime than larceny because it involves both theft and the risk of harm to people.

Elements:

1. Trespassory taking and carrying away.
2. Personal property of another.
3. Intent to permanently deprive the owner.
4. Use of force, violence, or intimidation at the time of taking.

Examples:

- A thief grabs a woman's purse while pointing a gun at her.
- A mugger punches someone and takes his wallet.
- Even threatening words—"Hand over your phone or else"—can satisfy the force/intimidation requirement.

Defenses:

- **No Force or Intimidation:** If the property was taken without threat or violence, the crime may be reduced to larceny.
  - *Example:* Picking a wallet from a purse without the victim noticing.
- **Voluntary Surrender:** If the property was given voluntarily without intimidation, it may not qualify as robbery.
  - *Example:* A panhandler receives money from someone who claims later they "felt pressured."
- **Mistaken Identity:** Common in robbery cases where victims must identify the perpetrator.
  - *Example:* A victim incorrectly identifies someone based on clothing seen at night.

Embezzlement

Definition: The fraudulent conversion of property by someone who is already in lawful possession of it. Unlike larceny, the initial possession is lawful, but the later use of the property is fraudulent.

Elements:

1. Lawful possession of property (not mere custody).
2. Fraudulent conversion or use of the property.
3. Property of another.
4. Intent to defraud the owner.

Examples:

- A bank teller takes money out of a cash drawer and spends it.
- A lawyer entrusted with client funds diverts them into his personal account.
- An employee with company credit card access uses it for personal vacation expenses.

Defenses:

- **Lack of Intent to Defraud:** The defendant intended to return the property or funds.
  - *Example:* An employee uses company money to pay a personal bill but replaces it before discovery.
- **Authorization:** If the defendant reasonably believed they were authorized to use the funds.
  - *Example:* A manager reimburses personal travel expenses believing they were covered by the company policy.
- **No Conversion:** Mere possession or temporary misuse without exercising ownership-like control may not be enough.

False Pretenses

Definition: Obtaining title (ownership) to property through intentional misrepresentation of a material fact with intent to defraud. Unlike larceny, which involves trespassory taking, false pretenses involve **voluntary transfer** of property because of deception.

Elements:

1. False representation of a material fact.
2. Knowledge of falsity (intent to deceive).
3. Reliance by the victim.
4. Transfer of title (not just possession).

Examples:

- Selling a car while rolling back the odometer and lying about the mileage.
- A scammer convinces a homeowner to invest in a "sure-fire" business venture and pockets the money.
- A person impersonates a landlord and collects rent from unsuspecting tenants.

Defenses:

- **No Intent to Defraud:** The defendant believed their statement was true.
  - *Example:* Selling a car while genuinely believing it had never been in an accident.
- **No Material Misrepresentation:** If the misstatement was not material to the transaction.
  - *Example:* Exaggerating minor cosmetic flaws that do not affect value.
- **Victim Did Not Rely:** If the victim knew the statement was false but proceeded anyway.
  - *Example:* A buyer knowingly purchases "counterfeit" watches at a flea market.

Receiving Stolen Property

One who knowingly engages in receiving stolen property is guilty of a crime, punishable either as a felony or misdemeanor depending on the value of the property. The law treats the receiver as culpable as the thief because without a market for stolen goods, theft itself would be less profitable.

The **receipt** of stolen property need not be personal or physical. If the property is delivered to a location under the receiver's control—such as their home, warehouse, or even a locker—the law deems that person to have received it.

Importantly, the requirement of **knowledge** is construed broadly. A conviction may rest not only on actual knowledge but also on:

- **Correct belief** that the property is stolen.
- **Suspicion strong enough** that the person deliberately avoids investigating for fear of confirming the property's stolen nature (so-called *willful blindness*).

Examples

- **Pawn Shop Case:** A pawn broker accepts a set of expensive tools for $50, knowing that the seller is not the type to own such items. Even if he does not ask questions, the circumstances make it clear that he should have known the tools were stolen.
- **Electronics Purchase:** A college student buys a "brand-new" laptop for $100 from someone in a parking lot. The student suspects the deal is "too good to be true" but chooses not to ask questions. Courts would likely find sufficient knowledge or belief to convict.
- **Delivery to a Warehouse:** A stolen shipment of televisions is delivered to a warehouse leased by a small retailer. Even if the owner does not physically unload them, having them delivered to his controlled space satisfies the "receipt" requirement if he knew (or strongly suspected) they were stolen.
- **Willful Blindness:** A used-car dealer buys a car with the VIN plate obviously tampered with. By ignoring this red flag, the dealer cannot later argue ignorance; the law treats deliberate avoidance as knowledge.

Common Defenses

1. **Lack of Knowledge**
   - The defendant did not know, nor had reason to know, the property was stolen.
   - *Example:* Buying a used laptop at a garage sale for a reasonable price, unaware that it had been stolen from a neighbor.
2. **Belief of Lawful Ownership**
   - The defendant honestly believed they were the true owner or had a valid claim to the property.
   - *Example:* A person accepts delivery of furniture believing it was part of a legitimate inheritance.
3. **No Possession or Control**
   - Mere presence near stolen goods is not enough; the prosecution must prove actual possession or control.
   - *Example:* Riding in a friend's car that contains stolen electronics in the trunk, without knowledge or ability to control them.
4. **Entrapment**
   - If law enforcement induced the defendant to take possession of stolen goods they otherwise would not have accepted.
   - *Example:* A police sting operation pressures a person into buying items they initially refused.
5. **Property Not Actually Stolen**
   - If the property was not stolen at the time the defendant received it, no crime exists.
   - *Example:* Purchasing goods from a pawn shop that had already been recovered and released by police; at that point, the items are no longer "stolen."

Forgery

Forgery is the **false making or altering of a document of legal significance**, carried out with **intent to defraud**. What makes forgery distinct is that the instrument itself must be false—not simply that it contains a false statement. The law punishes both the **creation** of the forged instrument and the **uttering** (presentation or use) of such an instrument, even if the person uttering it did not commit the actual forgery.

Key Elements of Forgery

1. **False Writing or Alteration** – The document is falsely made, materially altered, or otherwise tampered with.
2. **Of Legal Significance** – The writing must have legal importance, such as contracts, deeds, checks, money orders, receipts, or negotiable instruments.
3. **Intent to Defraud** – The act must be done with the purpose of deceiving another for personal gain or to cause loss.

Common Scenarios of Forgery

- **Checks and Financial Instruments** –
  - Signing your neighbor's name on his check to withdraw money is forgery.
  - Creating a fake cashier's check and attempting to deposit it at a bank is also forgery.
- **False Alterations** –
  - Changing the date on a contract to make it appear valid when it is not.
  - Altering the dollar amount on a money order or check.
- **Backdating Documents** –
  - Backdating a deed to suggest ownership at an earlier date, with intent to mislead.
- **Corporate Misrepresentation** –
  - Modifying a corporate name to resemble a legitimate business (e.g., "Wal-Mart Inc." altered to "Wall-Mart Inc.") on contracts or invoices.
- **Filling in Blanks** –
  - Taking a signed but incomplete contract or promissory note and filling in unauthorized terms.

Examples

- A college student prints fake concert tickets on a home computer and sells them online. Even if buyers never attempt to use them, the act of making the tickets constitutes forgery.

- A real estate agent alters the purchase price on a signed offer without the buyer's knowledge, then submits it to the seller. This alteration changes the legal significance of the document and amounts to forgery.
- An employee "finds" an unsigned company check, fills in her name, and signs a manager's signature before cashing it. She is guilty of both forgery and uttering a forged instrument.

Defenses to Forgery

- **Lack of Intent to Defraud**
  - No conviction without intent to deceive or cheat.
  - *Example:* A student makes a fake doctor's note as a prank but never tries to use it.
- **Consent or Authority**
  - Signing or altering a document with permission is not forgery.
  - *Example:* An office assistant signs the boss's checks with explicit authorization.
- **Document Not Legally Significant**
  - The writing must have legal importance to be forgery.
  - *Example:* Altering a doodle with a fake signature is not forgery because it carries no legal weight.
- **Mistake or Lack of Knowledge**
  - Passing or signing a document without knowing it is false defeats intent.
  - *Example:* Delivering a check that turns out to be forged, without realizing it.
- **Duress**
  - A person forced to commit forgery under threat may raise this defense.
  - *Example:* Signing another's name while at gunpoint.
- **Entrapment**
  - Law enforcement cannot induce someone to commit forgery they otherwise would not.
  - *Example:* An undercover agent repeatedly pressures someone to sign a false name.

Extortion

At **common law**, extortion could only be committed by a **public official** who corruptly demanded money or other benefits not due to him, using the power of his office. For example, a **city building inspector** who refuses to issue a required permit unless he is secretly paid would have committed extortion. The wrongful act was tied to the abuse of public authority.

Modern Statutory Extortion

Today, most jurisdictions have broadened the definition of extortion beyond government officials. Under modern statutes, extortion generally refers to the **wrongful obtaining of money, property, or something of value from another person through the use of threats**. Importantly, the threat does not need to be of **immediate physical violence**—if it were, the offense would usually be classified as **robbery**. Instead, extortion typically involves threats to reputation, economic interests, or personal relationships.

This broader form of extortion is commonly known as **blackmail**.

Key Elements of Extortion

1. **A Threat** – To harm the victim's person, property, reputation, or relationships.
2. **Intent to Obtain Value** – The threat is made with the purpose of obtaining money, property, services, or something else of value.
3. **Wrongfulness** – The demand and the threat are unlawful.

Examples of Extortion / Blackmail

- **Threats to Reputation**: A former employee threatens to tell the press that a company is engaging in tax fraud unless the company pays him $50,000.
- **Exposure of Private Information**: A person threatens to release compromising photographs of a celebrity unless paid for silence.

- **False Accusations**: An individual threatens to accuse a co-worker of sexual harassment unless given a promotion.
- **Economic Coercion**: A union leader threatens to call a strike unless an employer makes an unrelated personal payment to him.
- **Public Official Abuse**: A health inspector refuses to approve a restaurant's reopening unless the owner provides him with free meals for a year.

Distinguishing Extortion from Robbery

- **Robbery**: Involves the use or threat of **immediate physical harm** to take property.
- **Extortion**: Involves the use of threats (to reputation, future harm, or exposure of information) to obtain value.

Defenses to Extortion

- **Lack of Threat**
  - If no unlawful threat was made, there is no extortion.
  - *Example:* Demanding repayment of a legitimate debt is not extortion.
- **Consent / Legitimate Claim of Right**
  - A person seeking money or property they are legally entitled to may have a defense.
  - *Example:* A landlord demanding overdue rent.
- **Lack of Intent to Wrongfully Obtain Value**
  - Extortion requires intent to unlawfully gain something of value.
  - *Example:* A heated argument with vague statements that were not meant as threats.
- **Insufficient Evidence of Threat**
  - Words or actions must clearly amount to a threat of harm or exposure.
  - *Example:* Casual remarks or jokes may not rise to the level of extortion.
- **Duress**
  - If the accused was forced to make the threat by another person, duress may excuse the conduct.
- **Entrapment**
  - If law enforcement induced someone to commit extortion they otherwise would not, entrapment may apply.

Offenses against Habitation and Other Offenses

Burglary

Traditionally, burglary was not classified as a crime against property, but rather as a crime against the **security of habitation**—the sanctity of a person's home. At **common law**, burglary was defined as *"the breaking and entering of the dwelling of another in the nighttime with intent to commit a felony."*

Importantly, burglary does not require theft. For example, a man who sneaks into a woman's home at night with the intent to commit rape has committed burglary, even if the act itself is never carried out.

Breaking

- Courts interpret "breaking" broadly. Actual destruction is not required.
- Simply opening a closed but unlocked door, raising a window, or pushing open a screen is enough.
- Example: Entering through an open door is not a burglary, but pushing it further open—even slightly—qualifies as "breaking."

Entering

- Any part of the body crossing the threshold counts as entry.
- Example: If a burglar reaches an arm through a window to grab jewelry, the entry element is satisfied.

Nighttime

- At common law, burglary had to occur at night, defined as the period when there is not enough natural light to recognize a person's face.
- Modern statutes often eliminate this requirement, making burglary possible at any time of day.

Intent to Commit a Felony

- The burglar must have intent to commit a felony inside the dwelling—whether theft, assault, rape, or another serious offense.
- The crime is complete once the entry occurs with felonious intent, even if the intended felony is never carried out.
- Example: A person breaking in with the intent to steal but fleeing empty-handed is still guilty of burglary.

Whose Dwelling?

- Burglary requires unlawful entry into the dwelling of **another**.
- A landlord can burglarize the apartment of a tenant, because while the landlord owns the property, the tenant has lawful possession.
- By contrast, a person cannot burglarize their own home.

Modern Burglary Statutes

Most states have broadened burglary statutes beyond the narrow common-law definition. Modern laws often include:

- Entry into **any structure** (stores, offices, cars, boats, not just dwellings).
- Burglary at **any time of day** (not just at night).
- Different degrees of burglary based on whether the dwelling is occupied, whether a weapon is used, or whether injury occurs.

Examples

- A man pries open the back door of a house at midnight intending to steal electronics. Even if the homeowner scares him off, burglary is complete.
- A woman enters a pharmacy during business hours but hides inside until after closing, planning to steal prescription drugs. This counts as burglary under modern statutes, even without nighttime or "breaking."
- A teenager enters a neighbor's garage through an unlocked side door, intending to steal tools. Even though there is no force and it is daylight, modern statutes classify this as burglary.

Arson

At **common law**, arson was defined narrowly as *"the malicious burning of the dwelling of another."* Several important limits applied:

- **Malicious**: The fire had to be set willfully or with reckless disregard, not by accident.
- **Dwelling of another**: Only houses or living places belonging to someone else were covered. Burning one's own home—even to commit fraud—was not arson.
- **Burning**: There had to be actual damage to the structure, not just smoke or scorching.

Modern Statutes

Today, nearly all states have expanded the definition of arson well beyond the common law:

- **Any structure**: It is a felony to intentionally burn *any* building—homes, businesses, cars, boats, or even open fields.
- **Ownership irrelevant**: Setting fire to your own property (such as your home or car) is arson if it endangers others or is done to defraud (e.g., collecting insurance).
- **Degrees of arson**: Modern statutes often divide arson into degrees:
  - *First-degree*: Burning an occupied dwelling or causing serious risk to human life.

- *Second-degree*: Burning an unoccupied building or other structure.
- *Third-degree*: Burning personal property without consent.

Examples

- A person sets fire to his own warehouse to collect on fire insurance. Under common law this was not arson, but under modern statutes it is a felony.
- An employee, angry at his boss, sets fire to the office building at night when no one is inside. Even without injury, this is arson under modern law.
- A college student sets fire to a rival's car after a football game. Because vehicles are included under modern statutes, this counts as arson.
- A farmer burns his own field as part of seasonal clearing. This is not arson if done safely and without intent to defraud or endanger others.

Bribery

Bribery is the offering, giving, receiving, or soliciting of something of value with the intent to influence the action of a public official (or someone performing a public function). The payment does not have to be in cash—it can be goods, services, favors, or anything else that the recipient finds valuable.

Common Law vs. Modern Statutes

- **Common law**: Only public officials (e.g., judges, legislators) could be bribed.
- **Modern statutes**: The scope has broadened to include *anyone performing a public function*, such as jurors, inspectors, or even private contractors acting on behalf of the government. Many states also criminalize commercial bribery in the private sector (e.g., bribing an employee to betray an employer's interests).

Key Elements of Bribery

1. **Something of value** must be offered, given, received, or solicited.
2. **Corrupt intent**—the purpose is to improperly influence official action.
3. **Official action or duty**—the bribe must relate to an official or quasi-official role.

Examples

- A building inspector accepts $5,000 from a contractor in exchange for overlooking safety violations on a project.
- A juror is promised a vacation if they vote "not guilty" in a criminal trial.
- A U.S. company pays a foreign official to secure a lucrative oil contract. Under U.S. law, this violates the **Foreign Corrupt Practices Act (FCPA)**, which makes bribing foreign officials illegal even if the conduct occurs outside the United States.
- In the private sector, a purchasing manager accepts a kickback from a supplier to secure a contract, harming fair competition.

Penalties

Bribery is typically charged as a felony, carrying significant fines, prison sentences, and disqualification from holding public office. Under federal law and the FCPA, companies can face multimillion-dollar penalties and reputational harm in addition to criminal liability for executives.

Perjury

Perjury is the crime of willfully making a false statement under oath in a judicial or other official proceeding. When someone deliberately lies after swearing to tell the truth, the integrity of the judicial system is undermined. Because courts depend on honest testimony to establish facts, perjury is considered a serious offense.

Key Elements of Perjury

To convict someone of perjury, prosecutors generally must prove:

1. **Oath or affirmation** – The false statement was made under oath or affirmation, whether in court, a deposition, or another official proceeding.
2. **False statement** – The statement was objectively false.
3. **Corrupt intent** – The speaker knew the statement was false or did not sincerely believe it was true.
4. **Materiality** – The falsehood must be *material*, meaning it could influence the outcome of the proceeding.

Clarifications

- **Innocent mistake**: Misremembering or being genuinely mistaken is *not* perjury.
- **Belief matters**: Even if the statement turns out to be factually correct, it is perjury if the person *believed it was false* at the time.
- **Evasive phrasing**: Saying "I don't remember" or "to the best of my knowledge" does not automatically shield a person if it can be proven they actually do remember and are deliberately lying.

Examples

- A witness in a criminal trial swears under oath that they saw the defendant in another city, when in fact they know the defendant was present at the crime scene.
- A corporate executive lies during a sworn deposition in a fraud case, claiming certain documents do not exist when he knows they were destroyed.
- In a divorce proceeding, one spouse falsely testifies under oath that they have no offshore bank accounts, though they secretly do.
- Conversely, if a witness honestly misstates the color of a car involved in an accident, believing it was blue when it was actually green, that is *not* perjury—it is simply a mistake.

False Swearing vs. Perjury

While *perjury* usually refers to false statements under oath in judicial or official proceedings, lies under oath in other contexts (such as affidavits or administrative hearings) are often called **false swearing**. Many jurisdictions treat false swearing as a related but lesser offense.

Penalties

Perjury is typically a felony and can carry significant penalties, including:

- Prison sentences (often up to 5 years or more under federal law).
- Fines.
- Damage to credibility in future legal proceedings—anyone convicted of perjury is often impeached as a witness in later cases.

White-Collar Crime

White-collar crime, as distinguished from "street crime," generally refers to nonviolent, financially motivated offenses committed in business or professional settings. Unlike robbery, burglary, or assault, which typically involve force or threats, white-collar crimes are usually carried out through deception, fraud, or abuse of trust.

For example, **armed bank robbery** is not a white-collar crime because it involves force and intimidation. By contrast, **embezzlement** by a bank teller or executive—stealing money from within the institution—is a classic white-collar offense.

Key Characteristics

- Usually involves **fraud, misrepresentation, or deceit**.

- Committed in the course of business, government, or professional work.
- Can involve **abuse of a position of trust**.
- Financial gain is typically the goal, rather than physical harm.

Common Types of White-Collar Crimes

1. **Mail and Wire Fraud**
   - Any scheme to defraud that uses the U.S. Postal Service or interstate communication systems (phone, email, internet) violates federal law.
   - **Example:** A telemarketing scam where callers trick elderly victims into wiring money for fake investments.
2. **Securities Fraud**
   - Includes insider trading, stock manipulation, and Ponzi schemes.
   - **Example:** Executives at Enron used deceptive accounting to hide losses, misleading investors and employees.
3. **Embezzlement and False Pretenses**
   - Embezzlement occurs when someone entrusted with property unlawfully takes it for personal use.
   - False pretenses involve obtaining property through deliberate misrepresentation.
   - **Example:** A company bookkeeper diverts small amounts of money into a personal account over several years.
4. **Tax Fraud**
   - Filing false returns, hiding income, or creating fake deductions.
   - **Example:** Al Capone was famously convicted not for violent crimes, but for tax evasion in 1931.
5. **Price Fixing and Antitrust Violations**
   - Competitors illegally collude to set prices or restrict competition.
   - **Example:** In 2012, several international banks were fined billions for manipulating the LIBOR interest rate.
6. **Bribery and Corruption**
   - Paying (or receiving) money or favors in exchange for official action.
   - **Example:** Under the **Foreign Corrupt Practices Act (FCPA)**, U.S. companies have been prosecuted for bribing foreign officials to secure contracts.
7. **Regulatory Violations**
   - Violating health, safety, or environmental regulations.
   - **Example:** A pharmaceutical company mislabels a drug, resulting in FDA charges.
8. **Computer and Cyber Fraud**
   - The newest frontier of white-collar crime, including hacking, identity theft, phishing, and ransomware schemes.
   - **Example:** Hackers stealing credit card data from a major retailer's payment system and selling it on the dark web.

Why White-Collar Crime Matters

White-collar crime often causes **greater financial harm** to society than street crime. A robbery may involve hundreds of dollars, but a single fraudulent securities scheme can wipe out billions in retirement savings. Victims are not just corporations, but also everyday people whose pensions, savings, or taxes are affected.

Violations of the Federal Food, Drug, and Cosmetic Act (FDCA)

The **Federal Food, Drug, and Cosmetic Act (FDCA)** makes it a crime to send into interstate commerce any food, drug, cosmetic, or medical device that is **adulterated or misbranded**. Congress passed the Act to protect public health and ensure that consumers are not exposed to unsafe or deceptively marketed products.

What makes the FDCA unique is that, unlike most criminal statutes, **willfulness or deliberate misconduct is not required**. A person or corporation may be held criminally liable **even without intent to defraud or knowledge of the violation**. This strict liability approach reflects Congress's judgment that protecting consumers in these areas is so important that corporate officers must bear responsibility for ensuring compliance.

Examples of Violations

- **Improper Drug Marketing**: In 2010, pharmaceutical company **Allergan** pled guilty and paid a criminal fine for marketing **Botox** as a headache and pain reliever, even though the FDA had not approved it for those uses. Promoting drugs for "off-label" purposes—beyond what the FDA has authorized—is a violation of the FDCA.

- **Unsanitary Conditions**: In **United States v. Park (1975)**, the CEO of Acme Markets, Inc., was convicted when food in company warehouses became contaminated by rodents. Even though Park argued he had no personal knowledge of the violations, the Supreme Court upheld his conviction. The Court reasoned that corporate executives have a **"responsible relation"** to public health laws and a duty to prevent or correct violations under their supervision.
- **Cosmetic Misbranding**: A company that labels a skin cream as "FDA-approved" when it is not would be guilty of misbranding, even if the misstatement was due to oversight by lower-level employees.
- **Food Safety**: If a food manufacturer fails to properly test or monitor products for contamination—such as salmonella or listeria outbreaks traced to packaged foods—it can face FDCA liability, regardless of whether executives intended harm.

Environmental Crimes

Many federal **environmental protection statutes** include criminal provisions to ensure compliance and deter harmful conduct. These laws reflect Congress's judgment that pollution, toxic chemicals, and unsafe waste disposal threaten not only individuals but society at large. Because of the high stakes, corporate officers and businesses can face significant penalties—even imprisonment—when violations occur.

Key Statutes with Criminal Provisions

- **Clean Water Act (CWA)** – prohibits the discharge of pollutants into navigable waters without a permit.
- **Rivers and Harbors Act of 1899 (Refuse Act)** – one of the earliest federal laws protecting waterways, forbidding dumping of refuse without authorization.
- **Clean Air Act (CAA)** – regulates emissions of air pollutants from stationary and mobile sources.
- **Federal Insecticide, Fungicide, and Rodenticide Act (FIFRA)** – governs the distribution and use of pesticides.
- **Toxic Substances Control Act (TSCA)** – controls the manufacture, use, and distribution of certain chemicals.
- **Resource Conservation and Recovery Act (RCRA)** – regulates hazardous waste from its creation through storage, transportation, and disposal ("cradle-to-grave" management).

Example – Clean Water Act Violations

Under the **Clean Water Act**, wrongful discharge of pollutants into navigable waters can result in:

- Fines ranging from **$2,500 to $25,000 per day** of violation.
- Imprisonment for up to **one year**.

Importantly, the law does not excuse corporate executives from liability simply because they were not personally on-site. The **"responsible corporate officer" doctrine** allows prosecutors to charge officers who had authority over a project that caused pollution, even if subcontractors or lower-level employees carried out the actual discharge.

- **Case Example – U.S. v. Hanousek (1999):** Hanousek, a railroad roadmaster, was convicted under the Clean Water Act after subcontractors punctured an oil pipeline during a construction project, spilling oil into the Skagway River in Alaska. Although Hanousek was not physically present, the court held him criminally liable as a "responsible corporate officer" because he had authority over the project and its safety measures.

Other Examples of Environmental Crimes

- **RCRA Hazardous Waste:** A chemical company that knowingly stores toxic waste in unpermitted sites can face felony charges.
- **Clean Air Act:** A factory manager who allows illegal emissions of benzene (a known carcinogen) can be prosecuted.
- **FIFRA:** Selling or distributing unregistered pesticides, or mislabeling pesticide products, can result in criminal charges.

Violations of the Foreign Corrupt Practices Act

The **Foreign Corrupt Practices Act (FCPA)** of 1977 was passed in direct response to revelations from the **Watergate scandal**, where federal investigations uncovered that hundreds of U.S. corporations had paid millions of dollars in bribes to foreign officials to secure lucrative contracts. These practices not only distorted international markets but also undermined public trust

in American businesses abroad.

Key Provisions of the FCPA

1. **Accounting Requirements**
   - Publicly traded companies must maintain books, records, and accounts that **accurately and fairly reflect** all transactions.
   - Companies must also implement **internal accounting controls** to ensure accountability and transparency in the handling of assets.
   - This means no "slush funds" or off-the-books accounts to hide improper payments.
2. **Anti-Bribery Provisions**
   - It is **illegal to offer, promise, or pay anything of value** to a foreign official (or to an intermediary who will pass the money to such an official) for the purpose of influencing their decision or securing an improper advantage in obtaining or retaining business.
   - "Anything of value" goes beyond cash—it can include gifts, travel, entertainment, or charitable donations made with corrupt intent.
3. **Who Is Covered?**
   - U.S. citizens, residents, and businesses.
   - Public companies listed on U.S. stock exchanges.
   - Foreign companies and individuals who cause, directly or indirectly, an act in furtherance of a corrupt payment while in U.S. territory.

Examples of FCPA Enforcement

- **Siemens AG (2008):** The German engineering giant agreed to pay over **$800 million** in combined U.S. and German fines after investigations revealed widespread bribery across several countries to secure infrastructure contracts.
- **Walmart (2019):** Paid **$282 million** to settle allegations that its subsidiaries in Mexico, India, Brazil, and China failed to maintain adequate internal accounting controls, enabling improper payments to government officials.
- **Petrobras & Odebrecht (2016):** Brazilian companies were fined over **$3.5 billion**, the largest global foreign bribery settlement at the time, for paying massive bribes to government officials and politicians to secure contracts.

Why the FCPA Matters

The FCPA was groundbreaking because it was the first law in the world to make bribing foreign officials a crime. Initially, critics argued that it would put U.S. companies at a competitive disadvantage, since bribery was often seen as "business as usual" in many countries. But over time, the law influenced international standards, leading to agreements like the **OECD Anti-Bribery Convention (1997)**, which committed major economies to criminalize bribery abroad.

The Racketeer Influenced and Corrupt Organizations Act (RICO)

In **1970**, Congress enacted the **Racketeer Influenced and Corrupt Organizations Act (RICO)** as part of a broader effort to combat the Mafia and other forms of organized crime. The purpose was to stop crime families from infiltrating and controlling legitimate businesses by using threats, intimidation, or systematic fraud.

What makes RICO unique is that it does not just criminalize individual acts. Instead, it focuses on **patterns of illegal conduct** connected to an **"enterprise"** (a business, union, corporation, or even informal association). By targeting the enterprise itself, RICO aims to dismantle criminal organizations rather than just punishing individual offenders.

Key Provisions

- **Pattern of Racketeering:** A person must have committed at least **two or more predicate acts within ten years**. Predicate acts include a wide variety of crimes:
   - Mail and wire fraud
   - Securities fraud
   - Bribery

- Extortion
- Gambling offenses
- Money laundering
- Murder or kidnapping (when tied to the enterprise)

- **Enterprise Requirement:** The unlawful acts must be connected to an enterprise that affects interstate or foreign commerce.
- **Severe Penalties:**
  - Up to **20 years in prison** per racketeering count (life imprisonment if tied to certain violent crimes).
  - Forfeiture of assets obtained through illegal activity.
  - Treble damages (triple damages) in civil lawsuits, making RICO a powerful tool for private plaintiffs as well as prosecutors.

Examples of RICO in Action

1. **Organized Crime (Traditional Use):**
   - In the 1980s, federal prosecutors used RICO to convict key leaders of the New York Mafia's "Five Families." The law allowed prosecutors to show a pattern of extortion, loan sharking, and illegal gambling connected to the Mafia's control of unions and construction businesses.
2. **White-Collar Crime (Modern Use):**
   - **Enron Scandal (2000s):** Investors used civil RICO claims to pursue damages against accounting firms and executives involved in fraudulent financial practices.
   - **Health Care Fraud:** Doctors and clinics engaged in repeated false insurance claims have been charged under RICO when their actions formed a pattern of fraud.
3. **Unions and Corruption:**
   - RICO has been used against corrupt labor union officials who conspired with organized crime to skim money from pension funds or extort payments from employers.
4. **Sports and Entertainment:**
   - Civil suits have occasionally invoked RICO in cases alleging patterns of fraud or corruption in professional sports organizations, though not all succeed.

Criticism and Concerns

Because RICO tells courts to interpret it **"broadly to effectuate its remedial purpose,"** it has been used in contexts far beyond the Mafia. Critics argue that this broad application sometimes sweeps too widely, pulling in legitimate businesses and individuals for conduct that—while wrongful—may not resemble organized crime. For example, securities fraud or repeated contract misrepresentations have been charged under RICO, leading some to claim it has become a "catch-all" fraud statute.

Computer Crime

The Computer Fraud and Abuse Act (CFAA)

To address these crimes, Congress enacted the **Computer Fraud and Abuse Act (CFAA)** in 1986. The statute was designed to protect government and financial institution computers, as well as any computer used in interstate commerce (essentially, most computers connected to the internet).

Key CFAA provisions (see Table 6.1 in your text):

- **Access without Authorization:** It is a crime to access a computer without authorization or to exceed authorized access.
- **Damage to Protected Computers:** Knowingly causing damage to a "protected computer" (government, bank, or interstate commerce systems) is prohibited.
- **Fraud and Theft:** Using a computer to commit fraud, obtain money, or steal data is criminalized.
- **Password Trafficking:** Selling or distributing passwords for accessing computers involved in interstate commerce is illegal.

Example: In *United States v. Rodriguez* (2010), a Social Security Administration employee accessed personal records of acquaintances for nonbusiness purposes. Even though he did not sell the information, his unauthorized access violated the CFAA.

Federal vs. State Jurisdiction

Congress limited the CFAA to cases involving a **federal interest**—such as crimes against federal government systems, banks, or interstate commerce. However, many states have their own cybercrime statutes that cover purely local offenses, like unauthorized access to a state university's grading system.

Table 6.1 Summary of Provisions of the Computer Fraud and Abuse Act

Summary of Provisions of the Computer Fraud and Abuse Act

Obtaining national security information	Sec. (a)(1)	10 years maximum (20 years second offense)
Trespassing in a government computer	Sec. (a)(3)	1 year (5)
Compromising the confidentiality of a computer	Sec. (a)(2)	1 year (10)
Accessing a computer to defraud and obtain value	Sec. (a)4	5 years (10)
Intentional access and reckless damage	(a)(5)(A)(ii)	5 years (20)
Trafficking in passwords	(a)(6)	1 year (10)

KEY TAKEAWAY

Offenses can be against persons, against property, or against public policy (as when you bribe a public official, commit perjury, use public goods such as the mails or the Internet to commit fraud, or commit other white-collar crimes).

EXERCISES

1. Which does more serious harm to society: street crimes or white-collar crimes?
2. Why are various crimes so difficult to define precisely?
3. Hungry Harold goes by the home of Juanita Martinez. Juanita has just finished baking a cherry pie and sets it in the open windowsill to cool. Harold smells the pie from the sidewalk. It is twilight; while still light, the sun has officially set. Harold reaches into the window frame and removes the pie. Technically, has Harold committed burglary? What are the issues here based on the definition of burglary?
4. What is fraud? How is it different from dishonesty? Is being dishonest a criminal offense? If so, have you been a criminal already today?

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5.3: The Nature of a Criminal Act

LEARNING OBJECTIVES

1. Understand how it is possible to commit a criminal act without actually doing anything that you think might be criminal.
2. Analyze and explain the importance of intention in criminal law and criminal prosecutions.
3. Explain how a corporation can be guilty of a crime, even though it is a corporation's agents that commit the crime.

To be guilty of a crime, you must have acted. Mental desire or intent to do so is insufficient. But what constitutes an act? This question becomes important when someone begins to commit a crime, or does so in association with others, or intends to do one thing but winds up doing something else.

Attempt

It is not necessary to complete the intended crime to be guilty of a criminal offense. An **attempt** occurs when a person, with the intent to commit a crime, takes a substantial step toward carrying it out, even if the effort ultimately fails. Attempt crimes are usually punished less severely than the completed crime but still carry significant penalties.

- **Example – Attempted Murder:** Brett points a gun at Ashley intending to kill her. He pulls the trigger but misses. He can still be convicted of attempted murder.
- **Preparation vs. Attempt:** Simply preparing to commit a crime is not enough. For example, if Brett loads his gun at home and holsters it before leaving, most courts would not yet find attempt because he could still change his mind. The line between preparation and attempt is often a question for the jury.

Impossibility

A frequent defense raised in attempt cases is **impossibility**, but courts treat factual and legal impossibility differently.

- **Factual Impossibility (Not a Defense in Most States):**
  - Occurs when external facts make the crime impossible, even though the defendant intends it.
  - *Example:* A husband tries to poison his wife with what he thinks is strychnine, but the substance is sugar. He intended murder, but the act was impossible.
  - Most states reject factual impossibility as a defense.
- **Legal Impossibility (Usually a Defense):**
  - Occurs when the intended act, even if completed, would not be a crime.
  - *Example:* Barney shoots at a tree stump, believing it to be his neighbor Ralph. Because you cannot murder a stump, courts often recognize this as a defense.

Conspiracy

Conspiracy is a separate offense under federal and state law. It occurs when two or more people agree to commit a crime and take at least one **overt act** in furtherance of the plan.

- **Key Elements:**
  1. Agreement between two or more people.
  2. At least one overt act in furtherance of the conspiracy.
- **Example:** If three people agree to rob a bank and one buys a ski mask, all can be convicted of conspiracy to commit robbery.
- **Imputed Liability:** The acts of one conspirator are attributed to all.
  - *Example:* If one robber shoots a guard, all members of the conspiracy—including the lookout several blocks away—can be charged with murder.

Agency and Corporations

Criminal liability can extend through the law of agency.

- **Individual Liability via Agency:**
  - A person can commit a crime through another.
  - *Example:* A corporate officer tells an employee to deliver a bag to his home. The employee unknowingly delivers stolen company money. The employee is innocent, but the officer is guilty of larceny.
- **Limits of Agency Liability:**
  - Intent cannot be imputed where the principal did not share the intent.
  - *Example:* A sales manager extorts a customer to renew a contract. The company president, who only instructed "don't ignore our biggest customer," cannot be held criminally liable.
- **Corporate Criminal Liability:**
  - Corporations can be held criminally liable for acts of employees, especially if directed by responsible officers.
  - *Example:* Under antitrust laws, a corporation can be fined if executives engage in price-fixing.
  - Even shareholders, who had no role in the misconduct, bear the financial burden through corporate penalties.

KEY TAKEAWAY

Although proving the intent to commit a crime (the mens rea) is essential, the intent can be established by inference (circumstantially). Conspirators may not actually commit a crime, for example, but in preparing for a criminal act, they may be guilty of the crime of conspiracy. Certain corporate officers, as well, may not be directly committing criminal acts but may be held criminally responsible for acts of their agents and contractors.

EXERCISES

1. Give an example of how someone can intend to commit a crime but fail to commit one.
2. Describe a situation where there is a conspiracy to commit a crime without the crime actually taking place.
3. Create a scenario based on current events where a corporation could be found guilty of committing a crime even though the CEO, the board of directors, and the shareholders have not themselves done a criminal act.

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5.4: Procedure

LEARNING OBJECTIVES

1. Describe the basic steps in pretrial criminal procedure that follow a government's determination to arrest someone for an alleged criminal act.
2. Describe the basic elements of trial and posttrial criminal procedure.

Criminal Procedure

The procedure for criminal prosecutions in the United States is complex and varies somewhat from state to state, though the overall structure is fairly uniform across the country. Unlike civil cases, where the plaintiff seeks compensation, criminal cases involve the state (or federal government) pursuing punishment for acts defined as crimes. The following outlines the main stages of a criminal prosecution.

Arrest and Warrants

A criminal case typically begins with an **arrest**. If the defendant is caught in the act of committing a crime or while fleeing from the scene, the police may arrest without a warrant. Otherwise, police must obtain a **warrant for arrest** issued by a judge or magistrate.

- To obtain the warrant, law enforcement must present a **complaint** (a sworn statement) providing facts that establish **probable cause**—reasonable grounds to believe the accused committed the crime.
- Example: An officer cannot simply say, “I think Bonnie murdered Clyde.” She must present supporting evidence, such as witness statements, forensic evidence, or surveillance video.

Preliminary Hearing and Bail

Once arrested, the accused must be brought promptly before a magistrate for a **preliminary hearing**. The judge decides whether there is enough evidence to hold the accused for trial.

- If sufficient evidence exists, the accused may be **jailed** or released on **bail**.
- Bail is money or property posted as security to ensure the accused returns for trial. If the defendant fails to appear, the bail is forfeited.
- Example: A judge might deny bail if the accused has a history of fleeing the jurisdiction, but bail cannot be unreasonably high under the Eighth Amendment.

Filing of Charges – Information or Indictment

After the preliminary hearing, the prosecutor must formally bring charges:

- **Information**: A written statement by the prosecutor listing the charges.
- **Indictment**: A formal declaration by a **grand jury** (typically 23 citizens) that enough evidence exists to prosecute.
    - Grand juries do not decide guilt or innocence; they decide only whether the case should proceed to trial.
    - Example: In high-profile federal cases, such as those involving organized crime or political corruption, grand juries are often used.

Once indicted, the accused formally becomes a **defendant**.

Arraignment and Pleas

At the **arraignment**, the defendant appears in court to respond to the charges. The defendant may enter one of several pleas:

- **Not guilty** – leads to trial before a judge or jury (petit jury).
- **Guilty** – accepts responsibility and proceeds to sentencing.
- **Nolo contendere (no contest)** – the defendant neither admits nor denies guilt but accepts punishment.
  - Example: In antitrust or fraud cases, a nolo plea may help defendants avoid automatic liability in related civil lawsuits.

Plea bargaining is common. The defendant agrees to plead guilty to a lesser charge (e.g., larceny instead of robbery) in exchange for a lighter sentence recommendation by the prosecutor. Judges often, though not always, follow the prosecutor's recommendation.

Trial

If no plea agreement is reached, the case proceeds to trial. The defendant is presumed **innocent until proven guilty**, and conviction requires proof **beyond a reasonable doubt**.

- **Jury trial**: Most felony cases are tried before a jury.
- **Bench trial**: In some cases, the defendant may waive the right to a jury, and the judge alone decides the case.

Sentencing

If convicted, the defendant is sentenced by the judge. Sentencing typically follows the review of **presentencing reports** prepared by probation officers.

- Sentences may include imprisonment, fines, probation, community service, or combinations of these.
- Statutes often set **ranges** (e.g., "5–15 years"), and judges consider factors such as prior record, severity of the crime, and mitigating or aggravating circumstances.
- Example: A repeat offender convicted of armed robbery might face a long prison sentence, while a first-time offender convicted of embezzlement might receive probation and restitution.

Appeal

A convicted defendant has the right to at least one **appeal** to a higher court. Appeals do not retry the facts but focus on **legal errors** or **violations of constitutional rights** during the trial.

- Example: An appeal may argue that illegally obtained evidence (in violation of the Fourth Amendment) was admitted at trial or that the jury was improperly instructed.
- Until appeals are resolved, sentences may be delayed, though in many cases defendants begin serving their sentence immediately.

KEY TAKEAWAY

Criminal procedure in US courts is designed to provide a fair process to both criminal defendants and to society. The grand jury system, prosecutorial discretion, plea bargains, and appeals for lack of a fair trial are all part of US criminal procedure.

EXERCISES

1. Harold is charged with the crime of assault with a deadly weapon with intent to kill or inflict serious bodily injury. It is a more serious crime than simple assault. Harold's attorney wants the prosecutor to give Harold a break, but Harold is guilty of at

least simple assault and may also have had the intent to kill. What is Harold's attorney likely to do?

2. Kumar was driving his car, smoking marijuana, and had an accident with another vehicle. The other driver was slightly injured. When the officer arrived, she detected a strong odor of marijuana in Kumar's car and a small amount of marijuana in the glove compartment. The other driver expects to bring a civil action against Kumar for her injuries after Kumar's criminal case. What should Kumar plead in the criminal case—careless driving or driving under the influence?

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5.5: Constitutional Rights of the Accused

LEARNING OBJECTIVES

1. Explain the key constitutional protections provided to criminal defendants under the Fourth, Fifth, Sixth, and Eighth Amendments.
2. Illustrate how landmark Supreme Court cases have shaped and clarified these rights in practice.

Constitutional Rights of the Accused

We previously discussed both **search and seizure** and **double jeopardy** in **Chapter 4, Constitutional Law and U.S. Commerce**. Recall that the **Fourth Amendment** protects against unreasonable searches and seizures, and the **Fifth Amendment** prohibits the government from prosecuting a person twice for the same offense.

Here, we turn to other important rights of the accused under the **Fifth, Sixth, and Eighth Amendments**, which collectively safeguard fairness in criminal prosecutions.

Self-Incrimination

The Fifth Amendment protects individuals from being compelled to testify against themselves. Defendants cannot be forced to take the stand, nor can prosecutors comment on their silence. Confessions must also be voluntary.

- **Miranda v. Arizona (1966):** The Supreme Court required police to advise suspects of their rights—including the right to remain silent and the right to an attorney—before custodial interrogation. These *Miranda warnings* remain a cornerstone of criminal procedure.

Speedy Trial

The Sixth Amendment guarantees a speedy trial. While what counts as “speedy” depends on context, Congress codified the requirement in the **Speedy Trial Act of 1975**, requiring federal criminal prosecutions to begin within 75 days unless specific exceptions apply.

- **Barker v. Wingo (1972):** The Court held that a five-year delay in bringing a defendant to trial violated the speedy trial right, emphasizing that courts must balance factors such as the length of delay, reasons for delay, and prejudice to the defendant.

Cross-Examination

The Sixth Amendment gives defendants the right to confront witnesses against them. Testimony may only be admitted if the witness can be cross-examined by defense counsel.

- **Crawford v. Washington (2004):** The Court ruled that testimonial statements made by a witness absent from trial are inadmissible unless the defendant had a prior opportunity to cross-examine the witness. This strengthened the confrontation right in criminal trials.

Assistance of Counsel

Defendants have the constitutional right to legal representation under the Sixth Amendment.

- **Gideon v. Wainwright (1963):** The Court held that indigent defendants must be provided counsel at state expense in serious criminal cases. Clarence Gideon's handwritten petition from prison led to a landmark decision that reshaped the rights of the accused.
- **Powell v. Alabama (1932):** Known as the *Scottsboro Boys* case, the Court reversed convictions where defendants had been denied reasonable access to counsel in a capital case, reinforcing that fair trials require effective legal representation.

Cruel and Unusual Punishment

The Eighth Amendment bans punishments that are cruel and unusual.

- **Furman v. Georgia (1972):** The Supreme Court struck down existing death penalty statutes, ruling that their arbitrary and inconsistent application violated the Eighth Amendment.
- **Gregg v. Georgia (1976):** The Court upheld revised death penalty laws, allowing capital punishment to continue if applied fairly and with adequate procedural safeguards.
- **Atkins v. Virginia (2002):** The Court held that executing individuals with intellectual disabilities constitutes cruel and unusual punishment.

Presumption of Innocence

Defendants are presumed innocent until proven guilty, and conviction requires proof **beyond a reasonable doubt**.

- **In re Winship (1970):** The Court held that proof beyond a reasonable doubt is required in all criminal prosecutions, including cases involving juveniles. This case solidified the presumption of innocence as a constitutional guarantee.

KEY TAKEAWAY

The Constitution provides critical protections for those accused of crimes, ensuring fairness through rights such as freedom from unreasonable searches and seizures, protection against double jeopardy and self-incrimination, the right to counsel and a speedy trial, and freedom from cruel and unusual punishment. These safeguards balance the government's power to prosecute with the individual's right to due process and justice.

EXERCISES

1. Do you think it is useful to have a presumption of innocence in criminal cases? What if there were not a presumption of innocence in criminal cases?
2. Do you think public humiliation, public execution, and unusual punishments would reduce the amount of crime? Why do you think so?
3. "Due process" is another phrase for "fairness." Why should the public show fairness toward criminal defendants?

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5.6: Cases

False Pretenses

State v. Mills

96 Ariz. 377, 396 P.2d 5 (Ariz. 1964)

LOCKWOOD, VICE CHIEF JUSTICE

Defendants appeal from a conviction on two counts of obtaining money by false pretenses in violation of AR.S. §§ 13-661.A3. and 13-663.A1. The material facts, viewed "...in the light most favorable to sustaining the conviction," are as follows: Defendant William Mills was a builder and owned approximately 150 homes in Tucson in December, 1960. Mills conducted his business in his home. In 1960 defendant Winifred Mills, his wife, participated in the business generally by answering the telephone, typing, and receiving clients who came to the office.

In December 1960, Mills showed the complainant, Nathan Pivowar, a house at 1155 Knox Drive and another at 1210 Easy Street, and asked Pivowar if he would loan money on the Knox Drive house. Pivowar did not indicate at that time whether he would agree to such a transaction. Later in the same month Nathan Pivowar told the defendants that he and his brother, Joe Pivowar, would loan $5,000 and $4,000 on the two houses. Three or four days later Mrs. Mills, at Pivowar's request, showed him these homes again.

Mills had prepared two typed mortgages for Pivowar. Pivowar objected to the wording, so in Mills' office Mrs. Mills retyped the mortgages under Pivowar's dictation. After the mortgages had been recorded on December 31, 1960, Pivowar gave Mills a bank check for $5,791.87, some cash, and a second mortgage formerly obtained from Mills in the approximate sum of $3,000. In exchange Mills gave Pivowar two personal notes in the sums of $5,250.00 and $4,200.00 and the two mortgages as security for the loan.

Although the due date for Mills' personal notes passed without payment being made, the complainant did not present the notes for payment, did not demand that they be paid, and did not sue upon them. In 1962 the complainant learned that the mortgages which he had taken as security in the transaction were not first mortgages on the Knox Drive and Easy Street properties. These mortgages actually covered two vacant lots on which there were outstanding senior mortgages. On learning this, Pivowar signed a complaint charging the defendants with the crime of theft by false pretenses.

On appeal defendants contend that the trial court erred in denying their motion to dismiss the information. They urge that a permanent taking of property must be proved in order to establish the crime of theft. Since the complainant had the right to sue on the defendants' notes, the defendants assert that complainant cannot be said to have been deprived of his property permanently. Defendants misconceive the elements of the crime of theft by false pretenses. Stated in a different form, their argument is that although the complainant has parted with his cash, a bank check, and a second mortgage, the defendants intend to repay the loan.

Defendants admit that the proposition of law which they assert is a novel one in this jurisdiction. Respectable authority in other states persuades us that their contention is without merit. A creditor has a right to determine for himself whether he wishes to be a secured or an unsecured creditor. In the former case, he has a right to know about the security. If he extends credit in reliance upon security which is falsely represented to be adequate, he has been defrauded even if the debtor intends to repay the debt. His position is now that of an unsecured creditor. At the very least, an unreasonable risk of loss has been forced upon him by reason of the deceit. This risk which he did not intend to assume has been imposed upon him by the intentional act of the debtor, and such action constitutes an intent to defraud.

* * *

The cases cited by defendants in support of their contention are distinguishable from the instant case in that they involved theft by larceny. Since the crime of larceny is designed to protect a person's possessory interest in property whereas the crime of false pretenses protects one's title interest, the requirement of a permanent deprivation is appropriate to the former. Accordingly, we hold that an intent to repay a loan obtained on the basis of a false representation of the security for the loan is no defense.

* * *

Affirmed in part, reversed in part, and remanded for resentencing.

CASE QUESTIONS

1. False pretenses is a crime of obtaining ownership of property of another by making untrue representations of fact with intent to defraud. What were the untrue representations of fact made by Mills?
2. Concisely state the defendant's argument as to why Pivowar has not been deprived of any property.
3. If Pivowar had presented the notes and Mills had paid, would a crime have been committed?

White-Collar Crimes

United States v. Park

421 U.S. 658 (1975)

MR. CHIEF JUSTICE BURGER delivered the opinion of the Court.

We granted certiorari to consider whether the jury instructions in the prosecution of a corporate officer under § 301 (k) of the Federal Food, Drug, and Cosmetic Act, 52 Stat. 1042, as amended, 21 U.S.C. § 331 (k), were appropriate under *United States v. Dotterweich*, 320 U.S. 277 (1943). Acme Markets, Inc., is a national retail food chain with approximately 36,000 employees, 874 retail outlets, 12 general warehouses, and four special warehouses. Its headquarters, including the office of the president, respondent Park, who is chief executive officer of the corporation, are located in Philadelphia, Pennsylvania. In a five-count information filed in the United States District Court for the District of Maryland, the Government charged Acme and respondent with violations of the Federal Food, Drug, and Cosmetic Act. Each count of the information alleged that the defendants had received food that had been shipped in interstate commerce and that, while the food was being held for sale in Acme's Baltimore warehouse following shipment in interstate commerce, they caused it to be held in a building accessible to rodents and to be exposed to contamination by rodents. These acts were alleged to have resulted in the food's being adulterated within the meaning of 21 U.S.C. §§ 342 (a)(3) and (4), in violation of 21 U.S.C. § 331 (k).

Acme pleaded guilty to each count of the information. Respondent pleaded not guilty. The evidence at trial demonstrated that in April 1970 the Food and Drug Administration (FDA) advised respondent by letter of insanitary conditions in Acme's Philadelphia warehouse. In 1971 the FDA found that similar conditions existed in the firm's Baltimore warehouse. An FDA consumer safety officer testified concerning evidence of rodent infestation and other insanitary conditions discovered during a 12-day inspection of the Baltimore warehouse in November and December 1971. He also related that a second inspection of the warehouse had been conducted in March 1972. On that occasion the inspectors found that there had been improvement in the sanitary conditions, but that "there was still evidence of rodent activity in the building and in the warehouses and we found some rodent-contaminated lots of food items."

The Government also presented testimony by the Chief of Compliance of the FDA's Baltimore office, who informed respondent by letter of the conditions at the Baltimore warehouse after the first inspection. There was testimony by Acme's Baltimore division vice president, who had responded to the letter on behalf of Acme and respondent and who described the steps taken to remedy the insanitary conditions discovered by both inspections. The Government's final witness, Acme's vice president for legal affairs and assistant secretary, identified respondent as the president and chief executive officer of the company and read a bylaw prescribing the duties of the chief executive officer. He testified that respondent functioned by delegating "normal operating duties" including sanitation, but that he retained "certain things, which are the big, broad, principles of the operation of the company and had "the responsibility of seeing that they all work together."

At the close of the Government's case in chief, respondent moved for a judgment of acquittal on the ground that "the evidence in chief has shown that Mr. Park is not personally concerned in this Food and Drug violation." The trial judge denied the motion, stating that *United States v. Dotterweich*, 320 U.S. 277 (1943), was controlling.

Respondent was the only defense witness. He testified that, although all of Acme's employees were in a sense under his general direction, the company had an "organizational structure for responsibilities for certain functions" according to which different phases of its operation were "assigned to individuals who, in turn, have staff and departments under them." He identified those individuals responsible for sanitation, and related that upon receipt of the January 1972 FDA letter, he had conferred with the vice president for legal affairs, who informed him that the Baltimore division vice president "was investigating the situation

immediately and would be taking corrective action and would be preparing a summary of the corrective action to reply to the letter." Respondent stated that he did not "believe there was anything [he] could have done more constructively than what [he] found was being done."

On cross-examination, respondent conceded that providing sanitary conditions for food offered for sale to the public was something that he was "responsible for in the entire operation of the company" and he stated that it was one of many phases of the company that he assigned to "dependable subordinates." Respondent was asked about and, over the objections of his counsel, admitted receiving, the April 1970 letter addressed to him from the FDA regarding insanitary conditions at Acme's Philadelphia warehouse. He acknowledged that, with the exception of the division vice president, the same individuals had responsibility for sanitation in both Baltimore and Philadelphia. Finally, in response to questions concerning the Philadelphia and Baltimore incidents, respondent admitted that the Baltimore problem indicated the system for handling sanitation "wasn't working perfectly" and that as Acme's chief executive officer he was "responsible for any result which occurs in our company."

At the close of the evidence, respondent's renewed motion for a judgment of acquittal was denied. The relevant portion of the trial judge's instructions to the jury challenged by respondent is set out in the margin. Respondent's counsel objected to the instructions on the ground that they failed fairly to reflect our decision in *United States v. Dotterweich supra*, and to define "'responsible relationship.'" The trial judge overruled the objection. The jury found respondent guilty on all counts of the information, and he was subsequently sentenced to pay a fine of $50 on each count. The Court of Appeals reversed the conviction and remanded for a new trial.

* * *

The question presented by the Government's petition for certiorari in *United States v. Dotterweich*, and the focus of this Court's opinion, was whether the manager of a corporation, as well as the corporation itself, may be prosecuted under the Federal Food, Drug, and Cosmetic Act of 1938 for the introduction of misbranded and adulterated articles into interstate commerce. In *Dotterweich*, a jury had disagreed as to the corporation, a jobber purchasing drugs from manufacturers and shipping them in interstate commerce under its own label, but had convicted Dotterweich, the corporation's president and general manager. The Court of Appeals reversed the conviction on the ground that only the drug dealer, whether corporation or individual, was subject to the criminal provisions of the Act, and that where the dealer was a corporation, an individual connected therewith might be held personally only if he was operating the corporation as his 'alter ego.'

In reversing the judgment of the Court of Appeals and reinstating Dotterweich's conviction, this Court looked to the purposes of the Act and noted that they "touch phases of the lives and health of people which, in the circumstances of modern industrialism, are largely beyond self-protection. It observed that the Act is of "a now familiar type" which "dispenses with the conventional requirement for criminal conduct-awareness of some wrongdoing: In the interest of the larger good it puts the burden of acting at hazard upon a person otherwise innocent but standing in responsible relation to a public danger. Central to the Court's conclusion that individuals other than proprietors are subject to the criminal provisions of the Act was the reality that the only way in which a corporation can act is through the individuals, who act on its behalf.

* * *

The Court recognized that, because the Act dispenses with the need to prove "consciousness of wrongdoing," it may result in hardship even as applied to those who share "responsibility in the business process resulting in" a violation....The rule that corporate employees who have "a responsible share in the furtherance of the transaction which the statute outlaws" are subject to the criminal provisions of the Act was not formulated in a vacuum. Cf. *Morissette v. United States*, 342 U.S. 246, 258 (1952). Cases under the Federal Food and Drugs Act of 1906 reflected the view both that knowledge or intent were not required to be proved in prosecutions under its criminal provisions, and that responsible corporate agents could be subjected to the liability thereby imposed.

* * *

The rationale of the interpretation given the Act in *Dotterweich*...has been confirmed in our subsequent cases. Thus, the Court has reaffirmed the proposition that the public interest in the purity of its food is so great as to warrant the imposition of the highest standard of care on distributors.

Thus *Dotterweich* and the cases which have followed reveal that in providing sanctions which reach and touch the individuals who execute the corporate mission—and this is by no means necessarily confined to a single corporate agent or employee—the Act imposes not only a positive duty to seek out and remedy violations when they occur but also, and primarily, a duty to implement measures that will insure that violations will not occur. The requirements of foresight and vigilance imposed on responsible

corporate agents are beyond question demanding, and perhaps onerous, but they are no more stringent than the public has a right to expect of those who voluntarily assume positions of authority in business enterprises whose services and products affect the health and well-being of the public that supports them.

* * *

Reading the entire charge satisfies us that the jury's attention was adequately focused on the issue of respondent's authority with respect to the conditions that formed the basis of the alleged violations. Viewed as a whole, the charge did not permit the jury to find guilt solely on the basis of respondent's position in the corporation; rather, it fairly advised the jury that to find guilt it must find respondent "had a responsible relation to the situation," and "by virtue of his position...had...authority and responsibility" to deal with the situation.

The situation referred to could only be "food...held in unsanitary conditions in a warehouse with the result that it consisted, in part, of filth or...may have been contaminated with filth."

Our conclusion that the Court of Appeals erred in its reading of the jury charge suggests as well our disagreement with that court concerning the admissibility of evidence demonstrating that respondent was advised by the FDA in 1970 of insanitary conditions in Acme's Philadelphia warehouse. We are satisfied that the Act imposes the highest standard of care and permits conviction of responsible corporate officials who, in light of this standard of care, have the power to prevent or correct violations of its provisions.

* * *

Reversed.

CASE QUESTIONS

1. Did Park have criminal intent to put adulterated food into commerce? If not, how can Park's conduct be criminalized?
2. To get a conviction, what does the prosecutor have to show, other than that Park was the CEO of Acme and therefore responsible for what his company did or didn't do?

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5.7: Summary and Exercises

Summary

Criminal law is that branch of law governing offenses against society. Most criminal law requires a specific intent to commit the prohibited act (although a very few economic acts, made criminal by modern legislation, dispense with the requirement of intent). In this way, criminal law differs from much of civil law—for example, from the tort of negligence, in which carelessness, rather than intent, can result in liability.

Major crimes are known as felonies. Minor crimes are known as misdemeanors. Most people have a general notion about familiar crimes, such as murder and theft. But conventional knowledge does not suffice for understanding technical distinctions among related crimes, such as larceny, robbery, and false pretenses. These distinctions can be important because an individual can be found guilty not merely for committing one of the acts defined in the criminal law but also for attempting or conspiring to commit such an act. It is usually easier to convict someone of attempt or conspiracy than to convict for the main crime, and a person involved in a conspiracy to commit a felony may find that very little is required to put him into serious trouble.

Of major concern to the business executive is white-collar crime, which encompasses a host of offenses, including bribery, embezzlement, fraud, restraints of trade, and computer crime. Anyone accused of crime should know that they always have the right to consult with a lawyer and should always do so.

EXERCISES

1. Bill is the chief executive of a small computer manufacturing company that desperately needs funds to continue operating. One day a stranger comes to Bill to induce him to take part in a cocaine smuggling deal that would net Bill millions of dollars. Unbeknownst to Bill, the stranger is an undercover policeman. Bill tells the stranger to go away. The stranger persists, and after five months of arguing and cajoling, the stranger wears down Bill's will to resist. Bill agrees to take delivery of the cocaine and hands over a down payment of $10,000 to the undercover agent, who promptly arrests him for conspiracy to violate the narcotics laws. What defenses does Bill have?
2. You are the manager of a bookstore. A customer becomes irritated at having to stand in line and begins to shout at the salesclerk for refusing to wait on him. You come out of your office and ask the customer to calm down. He shouts at you. You tell him to leave. He refuses. So you and the salesclerk pick him up and shove him bodily out the door. He calls the police to have you arrested for assault. Should the police arrest you? Assuming that they do, how would you defend yourself in court?
3. Marilyn is arrested for arson against a nuclear utility, a crime under both state and federal law. She is convicted in state court and sentenced to five years in jail. Then the federal government decides to prosecute her for the same offense. Does she have a double-jeopardy defense against the federal prosecution?
4. Tectonics, a US corporation, is bidding on a project in Nigeria, and its employee wins the bid by secretly giving $100,000 to the Nigerian public official that has the most say about which company will be awarded the contract. The contract is worth $80 million, and Tectonics expects to make at least $50 million on the project. Has a crime under US law been committed?
5. Suppose that the CEO of Tectonics, Ted Nelson, is not actually involved in bribery of the Nigerian public official Adetutu Adeleke. Instead, suppose that the CFO, Jamie Skillset, is very accomplished at insulating both top management and the board of directors from some of the "operational realities" within the company. Skillset knows that Whoopi Goldmine, a Nigerian employee of Tectonics, has made the deal with Adeleke and secured the contract for Tectonics. Is it possible that Nelson, as well as Skillset, can be found guilty of a crime?
6. You have graduated from college and, after working hard for ten years, have scraped enough money together to make a down payment on a forty-acre farm within driving distance to the small city where you work in Colorado. In town at lunch one day, you run into an old friend from high school, Hayley Mills, who tells you that she is saving her money to start a high-end consignment shop in town. You allow her to have a room in your house for a few months until she has enough money to go into business. Over the following weeks, however, you realize that old acquaintances from high school are stopping by almost daily for short visits. When you bring this up to Hayley, she admits that many old friends are now relying on her for marijuana. She is not a licensed caregiver in Colorado and is clearly violating the law. Out of loyalty, you tell her that she has three weeks to move out, but you do not prevent her from continuing sales while she is there. What crime have you committed?
7. The Center Art Galleries—Hawaii sells artwork, and much of it involves art by the famous surrealist painter Salvador Dali. The federal government suspected the center of selling forged Dali artwork and obtained search warrants for six locations controlled by the center. The warrants told the executing officer to seize any items that were "evidence of violations of federal

criminal law." The warrants did not describe the specific crime suspected, nor did the warrants limit the seizure of items solely to Dali artwork or suspected Dali forgeries. Are these search warrants valid?*Center Art Galleries—Hawaii, Inc. v. United States*, 875 F.2d 747 (9th Cir. 1989).

SELF-TEST QUESTIONS

1. Jared has made several loans to debtors who have declared bankruptcy. These are unsecured claims. Jared "doctors" the documentation to show amounts owed that are higher than the debtors actually owe. Later, Jared is charged with the federal criminal offense of filing false claims. The standard (or "burden") of proof that the US attorney must meet in the prosecution is
    1. beyond all doubt
    2. beyond a reasonable doubt
    3. clear and convincing evidence
    4. a preponderance of the evidence
2. Jethro, a businessman who resides in Atlanta, creates a disturbance at a local steakhouse and is arrested for being drunk and disorderly. Drunk and disorderly is a misdemeanor under Georgia law. A misdemeanor is a crime punishable by imprisonment for up to
    1. one year
    2. two years
    3. five years
    4. none of the above
3. Yuan is charged with a crime. To find him guilty, the prosecutor must show
    1. actus reus and mens rea
    2. mens rea only
    3. the performance of a prohibited act
    4. none of the above
4. Kira works for Data Systems Ltd. and may be liable for larceny if she steals
    1. a competitor's trade secrets
    2. company computer time
    3. the use of Data Systems' Internet for personal business
    4. any of the above
5. Candace is constructing a new office building that is near its completion. She offers Paul $500 to overlook certain things that are noncompliant with the city's construction code. Paul accepts the money and overlooks the violations. Later, Candace is charged with the crime of bribery. This occurred when
    1. Candace offered the bribe.
    2. Paul accepted the bribe.
    3. Paul overlooked the violations.
    4. none of the above

SELF-TEST AnswerS

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

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6: INTRODUCTION TO TORT LAW

Learning Objectives

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

1. Know why most legal systems have tort law.
2. Identify the three kinds of torts.
3. Show how tort law relates to criminal law and contract law.
4. Understand negligent torts and defenses to claims of negligence.
5. Understand strict liability torts and the reasons for them in the US legal system.

In civil litigation, contract and tort claims are by far the most numerous. The law attempts to adjust for harms done by awarding damages to a successful plaintiff who demonstrates that the defendant was the cause of the plaintiff's losses. Torts can be intentional torts, negligent torts, or strict liability torts. Employers must be aware that in many circumstances, their employees may create liability in tort. This chapter explains the different kind of torts, as well as available defenses to tort claims.

6.1: Purpose of Tort Laws

6.2: Intentional Torts

6.3: Negligence

6.4: Strict Liability and Product Liability

6.5: Cases

6.6: Summary and Exercises

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6.1: Purpose of Tort Laws

LEARNING OBJECTIVES

1. Explain why a sound market system requires tort law.
2. Define a tort and give two examples.
3. Explain the moral basis of tort liability.
4. Understand the purposes of damage awards in tort.

Definition of *Tort*

The term *tort* is the French equivalent of the English word *wrong*. The word *tort* is also derived from the Latin word *tortum*, which means twisted or crooked or wrong, in contrast to the word *rectum,* which means straight (*rectitude* uses that Latin root). Thus conduct that is twisted or crooked and not straight is a tort. The term was introduced into the English law by the Norman jurists.

Long ago, *tort* was used in everyday speech; today it is left to the legal system. A judge will instruct a jury that a tort is usually defined as a wrong for which the law will provide a remedy, most often in the form of money damages. The law does not remedy all “wrongs.” The preceding definition of tort does not reveal the underlying principles that divide wrongs in the legal sphere from those in the moral sphere. Hurting someone’s feelings may be more devastating than saying something untrue about him behind his back; yet the law will not provide a remedy for saying something cruel to someone directly, while it may provide a remedy for "defaming" someone, orally or in writing, to others.

Although the word is no longer in general use, tort suits are the stuff of everyday headlines. More and more people injured by exposure to a variety of risks now seek redress (some sort of remedy through the courts). Headlines boast of multimillion-dollar jury awards against doctors who bungled operations, against newspapers that libeled subjects of stories, and against oil companies that devastate entire ecosystems. All are examples of tort suits.

The law of torts developed almost entirely in the common-law courts; that is, statutes passed by legislatures were not the source of law that plaintiffs usually relied on. Usually, plaintiffs would rely on the common law (judicial decisions). Through thousands of cases, the courts have fashioned a series of rules that govern the conduct of individuals in their noncontractual dealings with each other. Through contracts, individuals can craft their own rights and responsibilities toward each other. In the absence of contracts, tort law holds individuals legally accountable for the consequences of their actions. Those who suffer losses at the hands of others can be compensated.

Many acts (like homicide) are both criminal and tortious. But torts and crimes are different, and the difference is worth noting. A crime is an act against the people as a whole. Society punishes the murderer; it does not usually compensate the family of the victim. Tort law, on the other hand, views the death as a private wrong for which damages are owed. In a civil case, the tort victim or his family, not the state, brings the action. The judgment against a defendant in a civil tort suit is usually expressed in monetary terms, not in terms of prison times or fines, and is the legal system’s way of trying to make up for the victim’s loss.

Kinds of Torts

There are three kinds of torts: intentional torts, negligent torts, and strict liability torts. Intentional torts arise from intentional acts, whereas unintentional torts often result from carelessness (e.g., when a surgical team fails to remove a clamp from a patient’s abdomen when the operation is finished). Both intentional torts and negligent torts imply some fault on the part of the defendant. In strict liability torts, by contrast, there may be no fault at all, but tort law will sometimes require a defendant to make up for the victim’s losses even where the defendant was not careless and did not intend to do harm.

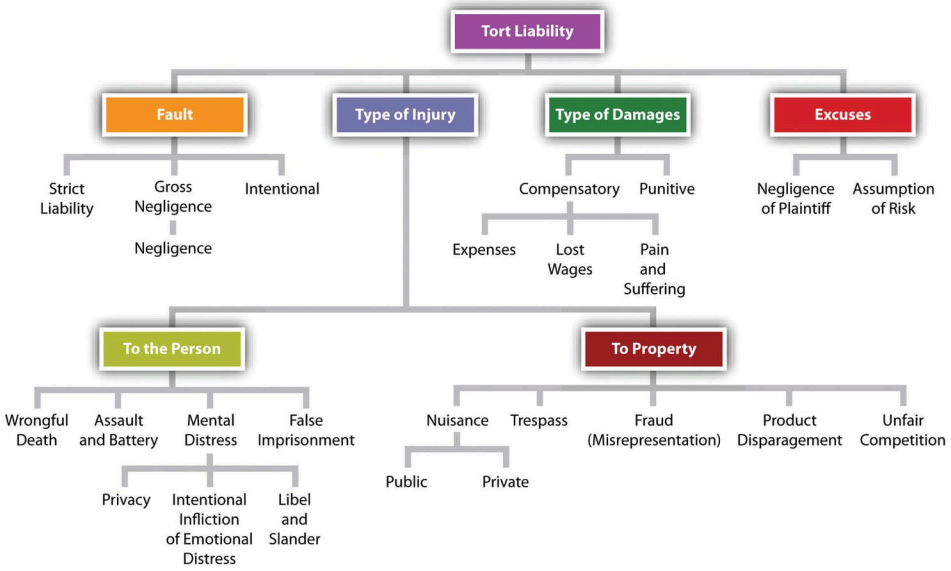
Dimensions of Tort Liability

There is a clear moral basis for recovery through the legal system where the defendant has been careless (negligent) or has intentionally caused harm. Using the concepts that we are free and autonomous beings with basic rights, we can see that when others interfere with either our freedom or our autonomy, we will usually react negatively. As the old saying goes, “Your right to

swing your arm ends at the tip of my nose." The law takes this even one step further: under intentional tort law, if you frighten someone by swinging your arms toward the tip of her nose, you may have committed the tort of assault, even if there is no actual touching (battery).

Under a capitalistic market system, rational economic rules also call for no negative externalities. That is, actions of individuals, either alone or in concert with others, should not negatively impact third parties. The law will try to compensate third parties who are harmed by your actions, even as it knows that a money judgment cannot actually mend a badly injured victim.

Figure 7.1 Dimensions of Tort Liability



Dimensions of Tort: Fault

Tort principles can be viewed along different dimensions. One is the **fault** dimension. Like criminal law, tort law requires a wrongful act by a defendant for the plaintiff to recover. Unlike criminal law, however, there need not be a specific intent. Since tort law focuses on injury to the plaintiff, it is less concerned than criminal law about the reasons for the defendant's actions. An innocent act or a relatively innocent one may still provide the basis for liability. Nevertheless, tort law—except for strict liability—relies on standards of fault, or blameworthiness.

The most obvious standard is willful conduct. If the defendant (often called the **tortfeasor**—i.e., the one committing the tort) intentionally injures another, there is little argument about tort liability. Thus all crimes resulting in injury to a person or property (murder, assault, arson, etc.) are also torts, and the plaintiff may bring a separate lawsuit to recover damages for injuries to his person, family, or property.

Most tort suits do not rely on *intentional* fault. They are based, rather, on negligent conduct that in the circumstances is careless or poses unreasonable risks of causing damage. Most automobile accident and medical malpractice suits are examples of negligence suits.

The fault dimension is a continuum. At one end is the deliberate desire to do injury. The middle ground is occupied by careless conduct. At the other end is conduct that most would consider entirely blameless, in the moral sense. The defendant may have observed all possible precautions and yet still be held liable. This is called **strict liability**. An example is that incurred by the manufacturer of a defective product that is placed on the market despite all possible precautions, including quality-control inspection. In many states, if the product causes injury, the manufacturer will be held liable.

Dimensions of Tort: Nature of Injury

Tort liability varies by the type of injury caused. The most obvious type is physical harm to the person (assault, battery, infliction of emotional distress, negligent exposure to toxic pollutants, wrongful death) or property (trespass, nuisance, arson, interference with

contract). Mental suffering can be redressed if it is a result of physical injury (e.g., shock and depression following an automobile accident). A few states now permit recovery for mental distress alone (a mother's shock at seeing her son injured by a car while both were crossing the street). Other protected interests include a person's reputation (injured by defamatory statements or writings), privacy (injured by those who divulge secrets of his personal life), and economic interests (misrepresentation to secure an economic advantage, certain forms of unfair competition).

Dimensions of Tort: Excuses

A third element in the law of torts is the excuse for committing an apparent wrong. The law does not condemn every act that ultimately results in injury.

One common rule of exculpation is **assumption of risk**. A baseball fan who sits along the third base line close to the infield assumes the risk that a line drive foul ball may fly toward him and strike him. He will not be permitted to complain in court that the batter should have been more careful or that management should have either warned him or put up a protective barrier.

Another excuse is negligence of the plaintiff. If two drivers are careless and hit each other on the highway, some states will refuse to permit either to recover from the other. Still another excuse is consent: two boxers in the ring consent to being struck with fists (but not to being bitten on the ear).

Damages

Since the purpose of tort law is to compensate the victim for harm actually done, damages are usually measured by the extent of the injury. Expressed in money terms, these include replacement of property destroyed, compensation for lost wages, reimbursement for medical expenses, and dollars that are supposed to approximate the pain that is suffered. Damages for these injuries are called **compensatory damages**.

In certain instances, the courts will permit an award of **punitive damages**. As the word *punitive* implies, the purpose is to punish the defendant's actions. Because a punitive award (sometimes called exemplary damages) is at odds with the general purpose of tort law, it is allowable only in aggravated situations. The law in most states permits recovery of punitive damages only when the defendant has deliberately committed a wrong with malicious intent or has otherwise done something outrageous.

Punitive damages are rarely allowed in negligence cases for that reason. But if someone sets out intentionally and maliciously to hurt another person, punitive damages may well be appropriate. Punitive damages are intended not only to punish the wrongdoer, by exacting an additional and sometimes heavy payment (the exact amount is left to the discretion of jury and judge), but also to deter others from similar conduct. The punitive damage award has been subject to heavy criticism in recent years in cases in which it has been awarded against manufacturers. One fear is that huge damage awards on behalf of a multitude of victims could swiftly bankrupt the defendant. Unlike compensatory damages, punitive damages are taxable.

KEY TAKEAWAY

There are three kinds of torts, and in two of them (negligent torts and strict liability torts), damages are usually limited to making the victim whole through an enforceable judgment for money damages. These compensatory damages awarded by a court accomplish only approximate justice for the injuries or property damage caused by a tortfeasor. Tort laws go a step further toward deterrence, beyond compensation to the plaintiff, in occasionally awarding punitive damages against a defendant. These are almost always in cases where an intentional tort has been committed.

EXERCISES

1. Why is deterrence needed for intentional torts (where punitive damages are awarded) rather than negligent torts?
2. Why are costs imposed on others without their consent problematic for a market economy? What if the law did not try to reimpose the victim's costs onto the tortfeasor? What would a totally nonlitigious society be like?

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6.2: Intentional Torts

LEARNING OBJECTIVES

1. Distinguish intentional torts from other kinds of torts.
2. Give three examples of an intentional tort—one that causes injury to a person, one that causes injury to property, and one that causes injury to a reputation.

Assault and Battery

Introduction

Two of the most common intentional torts are **assault** and **battery**. Although the terms are sometimes used interchangeably in everyday speech, the law treats them as distinct wrongs. Assault involves the creation of a reasonable apprehension of imminent harmful or offensive contact, while battery involves the actual harmful or offensive physical contact itself.

It is important to note that **assault and battery often occur together, but they are not dependent on one another.** An assault may occur without a battery, and a battery may occur without an assault.

Opening Scenario: *Western Union Telegraph Co. v. Hill*

In *Western Union Telegraph Co. v. Hill*, Mr. and Mrs. Hill went into a Western Union office to have a clock repaired. Mrs. Hill stepped up to the counter and spoke with the telegraph company's employee, Mr. Sapp. During the exchange, Sapp made an inappropriate proposition: he told Mrs. Hill that he would "fix the clock if she would give him a kiss." As he said this, he leaned across the counter and reached his hand toward her. The counter was wide enough that Sapp could not actually touch Mrs. Hill, but his sudden movement startled her. She immediately pulled back, feeling both shocked and threatened by his behavior. Although there was no physical contact, Mrs. Hill experienced fear and unease from the attempted advance.

Assault

Rule and Definition

Assault occurs when a person intentionally causes another to reasonably apprehend imminent harmful or offensive contact. No physical touching is necessary; the essence of the wrong is the creation of fear or expectation of immediate harm.

Elements of Assault

1. **Intent** – The defendant must act with intent to cause harmful or offensive contact, or intent to cause apprehension of such contact.
2. **Act** – The defendant must engage in conduct beyond mere words that creates the apprehension.
3. **Reasonable Apprehension** – The plaintiff must reasonably believe harmful or offensive contact is imminent.
4. **Immediate Harmful or Offensive Touching** – The apprehension must concern an immediate threat of harmful or offensive touching, not something distant or in the future.

Application to Scenario

In *Western Union Telegraph Co. v. Hill*, the telegraph employee's attempt to lean over the counter and kiss the plaintiff's wife created a reasonable apprehension of offensive contact. Although he could not actually reach her, the act was sufficient to raise the threat in her mind. This satisfies the elements of **assault**, even though no physical contact occurred.

Battery

Rule and Definition

Battery occurs when a person intentionally causes harmful or offensive physical contact with another without consent. Unlike assault, which focuses on fear of harm, battery requires the actual physical touching.

Elements of Battery

1. **Intent** – The defendant must act intending to cause a harmful or offensive contact.
2. **Act** – The defendant must engage in conduct that results in contact.
3. **Causing** – The act must directly or indirectly cause the contact with the plaintiff.
4. **Harmful or Offensive Contact** – The contact must either cause bodily harm or offend a reasonable sense of personal dignity.

Application to Scenarios

- In the actual facts, Mr. Sapp leaned forward and reached out, but the counter was wide enough that he could not touch Mrs. Hill. Since no contact occurred, there was **no battery**—though his actions could still amount to assault because they created apprehension of immediate harmful or offensive touching.
- Suppose that when Mr. Sapp leaned across the counter, he was able to reach far enough to brush his hand against Mrs. Hill's arm or shoulder. Even if the contact was brief and caused no physical injury, it would still count as **battery** because it was an intentional, offensive touching without her consent.

Transferred Intent

Rule and Definition

The **doctrine of transferred intent** provides that when a defendant intends to commit a tort against one person but instead causes the tortious contact or apprehension to another, the intent is "transferred" from the intended target to the actual victim. This doctrine ensures that wrongdoers cannot escape liability simply because their harmful act struck someone other than the person originally intended.

Under this rule, the defendant's liability extends to unintended victims if the essential elements of the tort are satisfied. This doctrine most commonly applies to intentional torts such as assault, battery, false imprisonment, trespass to land, and trespass to chattels.

Elements of Transferred Intent

1. **Intent to commit an intentional tort** – The defendant must have the requisite intent to commit an intentional tort (e.g., intent to cause harmful contact, offensive contact, or apprehension).
2. **Act** – The defendant performs an act directed at an intended target.
3. **Different victim** – The act instead results in harmful or offensive contact (battery) or apprehension (assault) with a different person.
4. **Liability** – The law transfers the defendant's intent to the actual victim, creating liability as if that person had been the intended target.

Application

Imagine that David angrily throws a heavy coffee mug at Mark, intending to hit him. Mark sees it coming and ducks just in time, but the mug instead strikes Sarah, who is standing nearby. Under the doctrine of transferred intent, David's intent to commit battery against Mark transfers to Sarah, the actual victim. Sarah may sue David for battery for any damages she suffers, even though she was never David's intended target.

This principle reinforces a key concept in tort law: **the focus is on the defendant's wrongful intent and act, not on the identity of the specific victim.** As long as the act and intent coincide to create harm or apprehension, liability will attach.

False Imprisonment

The tort of **false imprisonment** originally meant locking someone up in a prison cell, but today the concept is broader. A person may be falsely imprisoned if they are unlawfully restrained in any confined space—such as a room, a car, or even while walking down the street—so long as their freedom of movement is unlawfully restricted.

At its core, false imprisonment protects an individual's right to move freely. Any person who, without lawful justification, deprives another of the ability to leave or move about commits this tort.

Elements of False Imprisonment

1. **Intent** – The defendant must intend to confine or restrain the plaintiff.
2. **Act of Restraint** – The defendant's conduct must result in restraint or confinement. This may include physical barriers, physical force, threats of force, or assertion of legal authority (such as a false arrest).
3. **Bounded Area** – The plaintiff must be confined within boundaries fixed by the defendant.
4. **Awareness or Harm** – The plaintiff must either be aware of the confinement at the time or suffer harm as a result of it.

Damages

Victims of false imprisonment may recover damages for:

- Time lost and inconvenience caused by the confinement.
- Physical or emotional discomfort, including ill health or mental suffering.
- Humiliation and damage to reputation.
- Economic loss, such as lost business opportunities.
- Expenses incurred because of the restraint, including attorney's fees.

Case Illustration

In *Lester v. Albers Super Markets, Inc.*, the plaintiff claimed she had been falsely arrested by store personnel. The court emphasized that to recover damages, the plaintiff must prove that the defendant actually restrained her freedom of movement. Without proof of restraint, a false imprisonment claim cannot succeed.

Defense: The Shopkeeper's Privilege

A common defense to false imprisonment claims is the **shopkeeper's privilege**. This privilege allows merchants to detain customers for a reasonable period of time if they have a reasonable belief that the customer has stolen or attempted to steal goods.

To successfully assert this defense, the shopkeeper must show:

1. **Reasonable Cause** – There must be a good-faith, reasonable suspicion of theft.
2. **Reasonable Manner** – The detention must be carried out in a reasonable way (no excessive force, threats, or humiliation).
3. **Reasonable Time** – The detention must last only long enough to conduct a brief investigation or to summon the police.

Scenario: Shopkeeper's Privilege in Action

- **Lawful Detention**: A store clerk sees a customer place a small item in her bag without paying. The clerk politely stops the customer near the exit, explains the concern, and asks her to wait in a small office while security calls the police. The customer is detained for ten minutes, treated respectfully, and released once the police arrive. This would likely be considered a valid exercise of the **shopkeeper's privilege**.

- **Unlawful Detention (False Imprisonment)**: A store clerk suspects theft but has no clear evidence. The clerk locks the customer in a back room for two hours, refuses to let her call anyone, and yells accusations at her in front of other customers. In this case, the detention is **unreasonable in manner and time**, and the customer could sue for **false imprisonment**.

Intentional Infliction of Emotional Distress (IIED)

Rule and Definition

The tort of **intentional infliction of emotional distress (IIED)** occurs when a defendant engages in **extreme and outrageous conduct** with the intent (or reckless disregard) of causing severe emotional distress to another person, and that conduct actually results in such distress.

Courts stress that the conduct must go beyond mere insults or trivial annoyances; it must be so extreme in degree and outrageous in character that it goes beyond all bounds of decency tolerated in a civilized society.

Elements of IIED

1. **Intent or Recklessness** – The defendant must intend to cause severe emotional distress or act with reckless disregard of the likelihood of causing it.
2. **Extreme and Outrageous Conduct** – The defendant's conduct must be atrocious and utterly intolerable in a civilized community.
3. **Causation** – The defendant's conduct must cause the plaintiff's distress.
4. **Severe Emotional Distress** – The plaintiff must suffer distress that is substantial, not fleeting or trivial.

Case Illustration: *Howard Stern Case*

In *Fischer v. Howard Stern* (New York), Howard Stern received the cremated remains of a listener's father as part of a contest. On the air, Stern opened the package, displayed the ashes, and made crude jokes while handling the remains. The deceased's daughter was horrified when she learned how Stern treated her father's ashes and brought suit for intentional infliction of emotional distress.

The court considered whether Stern's actions could be deemed "extreme and outrageous" conduct sufficient to sustain an IIED claim. This case highlights how outrageous treatment of deeply personal matters—such as the mishandling of a loved one's remains—can cross the line into actionable IIED.

Negligent Infliction of Emotional Distress (NIED)

Rule and Definition

Unlike IIED, which requires intentional or reckless conduct, **negligent infliction of emotional distress (NIED)** arises when a defendant's **careless behavior** causes another person to suffer serious emotional harm. Courts have historically been cautious in recognizing this tort because emotional harm can be difficult to prove and quantify.

Theories of Recovery in NIED

1. **Zone of Danger Rule** – A plaintiff may recover if they were placed in immediate risk of physical harm due to the defendant's negligence and suffered emotional distress as a result.
    - Example: A driver negligently swerves and nearly hits a pedestrian, who escapes injury but develops severe anxiety and insomnia from the close call.
2. **Bystander Recovery** – A plaintiff may recover if they witness injury to a close relative caused by the defendant's negligence, even if they were not personally in danger.
    - Courts usually require the plaintiff to:

        - Be near the scene of the accident,
        - Witness it contemporaneously, and
        - Be closely related to the victim.
    - Example: A mother sees her child struck by a negligent driver and suffers severe emotional trauma.

Elements of NIED (General Framework)

1. **Duty of Care** – The defendant must owe a duty to the plaintiff.
2. **Breach** – The defendant must breach that duty through negligent conduct.
3. **Causation** – The negligent conduct must cause the plaintiff's emotional distress.
4. **Serious Emotional Harm** – The plaintiff must show genuine and serious emotional harm, often supported by medical evidence.

Trespass

Trespass to land occurs when a person intentionally enters land belonging to another without permission, or when a person places or leaves an object on another's land and refuses to remove it. The law strongly protects property owners' rights to exclusive possession and control of their land.

Elements of Trespass

To establish a claim of trespass, the plaintiff must prove:

1. **Ownership or Possession** – The plaintiff owns, leases, or lawfully possesses the land.
2. **Intent** – The defendant intentionally entered or caused an object to enter the land (intent to trespass is not required; intent to enter the land is enough).
3. **Unauthorized Entry** – The entry was without the plaintiff's permission or legal right.
4. **Interference** – The trespass interfered with the plaintiff's exclusive right to control the land.

Defenses to Trespass

- **Consent** – The property owner permitted the entry.
- **Necessity** – The entry was necessary to prevent a greater harm (e.g., entering property to save a person from danger).
- **Legal Authority** – Entry was authorized by law (e.g., police with a warrant, utility workers).

Case Illustration: *Katko v. Briney*

The case of *Katko v. Briney*, 183 N.W.2d 657 (Iowa 1971), illustrates the limits of property owners' rights.

- After years of trespassing, the Brineys rigged a spring-loaded shotgun to fire when a bedroom door was opened. Katko, a trespasser, was severely injured when he entered the boarded-up farmhouse.
- The court held that while trespassers have no right to enter unlawfully, landowners may not protect unoccupied property by using deadly force or devices capable of inflicting death or serious injury.

Nuisance

While trespass protects the right to exclusive possession of land, **nuisance** protects the right to use and enjoy property without unreasonable interference from others. Nuisance often involves activities that do not physically invade the land but still cause harm or discomfort, such as noise, smoke, odors, or vibrations.

Elements of Private Nuisance

To establish a private nuisance, the plaintiff must show:

1. **Ownership or Possessory Interest** – The plaintiff has a right to use and enjoy the property.
2. **Unreasonable Interference** – The defendant's conduct substantially and unreasonably interferes with that use and enjoyment.
3. **Causation** – The defendant's conduct caused the interference.
4. **Damages** – The plaintiff suffered harm (physical, financial, or emotional loss of use/enjoyment).

Case Illustration: The Sriracha Plant Case (Irwindale, California)

In 2013–2014, residents of Irwindale, California, complained that strong chili odors and fumes from the Huy Fong Foods Sriracha hot sauce factory caused burning eyes, throat irritation, and made it difficult to enjoy their homes. The city sued the plant, alleging that the odors constituted a **public nuisance**.

- The case illustrated how even lawful business operations can be deemed a nuisance if they interfere with the community's health and comfort.
- Eventually, the city and the company reached a settlement after Huy Fong installed stronger air filtration systems.

Defenses to Nuisance

- **Coming to the Nuisance** – The plaintiff moved into the area knowing of the defendant's existing activity (not always a complete defense but may limit damages).
- **Statutory Compliance** – The defendant's operations comply with government regulations (though this does not always bar nuisance claims).
- **Reasonableness/Utility of Conduct** – The defendant may argue that the usefulness of the activity outweighs the harm (balancing test).

Conversion

Rule and Definition

Conversion is the intentional interference with another person's right to possess personal property, where the defendant's conduct is so serious that it justifies requiring the defendant to pay the **full value** of the property.

Unlike **trespass to chattels**, which involves minor or temporary interference (such as brief use, borrowing without permission, or causing small damage), conversion represents such a substantial interference that it effectively deprives the owner of their property rights.

Conversion may occur through:

- **Wrongful taking** (e.g., stealing property),
- **Destruction** (e.g., burning or breaking property),
- **Misuse** (e.g., using property in a way that destroys its value), or
- **Refusal to return** property when lawfully demanded.

Elements of Conversion

To establish conversion, a plaintiff must show:

1. **Ownership or Right to Possession** – The plaintiff owned or had the legal right to possess the property.
2. **Intentional Act** – The defendant intentionally exercised control over the property.
3. **Serious Interference** – The defendant's actions seriously interfered with the plaintiff's right of control.

4. **Damages** – The plaintiff suffered loss, and the fair remedy is the property's full market value.

Remedies

The primary remedy for conversion is payment of the **fair market value** of the property at the time of the wrongful act. In many cases, this remedy is awarded instead of returning the property, since the property may be lost, destroyed, or too damaged to restore.

Examples

- **Conversion (Car Sale)**: A valet driver takes a customer's car without permission and sells it. Because the customer has been deprived of both the use and the value of the car, this constitutes conversion. Even if the car is later recovered, the owner may recover its full market value.
- **Trespass to Chattels (Minor Use)**: If the valet driver only takes the customer's car for a short, unauthorized ride around the block and returns it unharmed, this would likely be **trespass to chattels**, not conversion, because the interference was temporary and minor.

Defenses to Conversion

- **Consent** – The owner gave permission to use or take the property.
- **Necessity** – The property was taken or used to prevent a greater harm (though compensation may still be required).
- **Ownership Disputes** – The defendant reasonably believed they had a right to the property (good faith is not always a complete defense, but it may affect damages).

Intentional Interference with Contractual Relations

Rule and Definition

Intentional interference with contractual relations (also called tortious interference with a contract) occurs when a third party improperly disrupts an existing contract, causing one of the parties to breach or making performance impossible. This tort protects the stability of contractual agreements and ensures that parties can rely on their bargains without wrongful outside interference.

Elements of Tortious Interference with a Contract

To establish a claim, the plaintiff must show:

1. **Valid Contract** – There was a valid and enforceable contract between the plaintiff and a third party.
2. **Knowledge** – The defendant knew of the existence of the contract.
3. **Improper Interference** – The defendant intentionally and improperly induced the third party to breach the contract or otherwise prevented performance.
4. **Damages** – The plaintiff suffered injury as a result of the interference.

Case Illustration: *Pennzoil v. Texaco*

One of the most famous cases in this area is *Pennzoil Co. v. Texaco, Inc.*

- **Background**: Pennzoil was negotiating a takeover deal with Getty Oil. A memorandum of understanding was signed, and a press release announced an agreement in principle. Before the deal was finalized, Texaco offered Getty shareholders an additional $12.50 per share, later raising its bid even higher. Getty's board abandoned Pennzoil and accepted Texaco's offer.
- **Lawsuit**: Pennzoil sued Texaco in Texas state court for intentional interference with its contract with Getty.
- **Verdict**: A jury awarded Pennzoil $7.53 billion in actual damages and $3 billion in punitive damages. The verdict was so massive it threatened to bankrupt Texaco.

- **Appeals and Settlement**: Texaco appealed, arguing that no binding contract existed since the deal with Getty had not been completed. The Securities and Exchange Commission (SEC) supported Texaco's interpretation, but before the matter was fully resolved, Texaco agreed to pay $3 billion to Pennzoil to settle the case.

Defenses to Contract Interference

- **No Contract** – If there was no valid and enforceable contract, interference cannot be established.
- **Justification/Privilege** – Some interference may be legally justified, such as competition in business, provided it is carried out fairly and without improper means.
- **Consent** – If both contracting parties agreed to the third party's involvement, interference cannot be claimed.

Malicious Prosecution

Rule and Definition

Malicious prosecution is the tort of causing someone to be prosecuted for a criminal act, knowing that there was no probable cause to believe the plaintiff committed the crime. It is designed to protect individuals from being subjected to legal proceedings that are baseless, motivated by malice, or pursued for improper purposes.

Elements of Malicious Prosecution (Criminal Proceedings)

To succeed on a claim, the plaintiff must prove:

1. **Initiation of Proceedings** – The defendant caused a criminal proceeding to be initiated against the plaintiff (for example, seeking an arrest warrant or providing evidence leading to charges).
2. **Lack of Probable Cause** – There was no reasonable basis to believe the plaintiff committed the alleged offense.
3. **Malice or Improper Purpose** – The defendant acted out of malice or for reasons other than bringing the guilty to justice.
4. **Favorable Termination** – The criminal proceeding ended in the plaintiff's favor (e.g., charges dismissed, acquittal).
5. **Damages** – The plaintiff suffered harm, which may include loss of reputation, emotional distress, attorney's fees, and other costs.

Malicious Prosecution in Civil Proceedings

A majority of U.S. courts also recognize **wrongful civil proceedings** (sometimes called *abuse of process* or *malicious use of process*), though with stricter proof requirements.

- **Rationale**: Civil litigation is costly and burdensome, and one who forces another to defend against baseless claims should not be permitted to do so without consequence.
- **Public Policy Limitation**: Courts are cautious, since access to the courts is considered a fundamental right. The U.S. Supreme Court has held that individuals have a constitutional right to litigate, so the bar for proving wrongful civil proceedings is high.
- **Burden of Proof**: The plaintiff must show:
  1. The prior civil action was initiated without reasonable factual or legal basis.
  2. The defendant filed the lawsuit for an improper purpose (such as harassment, intimidation, or to force settlement).
  3. The prior action terminated in the plaintiff's favor.
  4. The plaintiff suffered damages as a result of defending the baseless suit.

Simply showing that the earlier lawsuit was dismissed is **not enough**; the plaintiff must prove both improper purpose and lack of reasonable belief in the merits of the original claim.

Defenses to Malicious Prosecution

- **Probable Cause** – If the defendant reasonably believed the plaintiff committed the crime (or that a civil claim was valid), the tort cannot be established.

- **Advice of Counsel** – Acting on the advice of a competent attorney after full disclosure may be a defense.
- **Favorable Termination Absent** – If the original proceeding did not end in the plaintiff's favor, the claim cannot go forward.

Defamation

Rule and Definition

Defamation is injury to a person's good name or reputation. A defamatory communication is one that tends to lower a person in the estimation of the community or to deter others from associating or dealing with them (*Restatement (Second) of Torts*, §559).

- **Slander**: Spoken defamation (in person, by phone, radio, or television).
- **Libel**: Written or otherwise published defamation (print, online, corporate materials).

Elements of Defamation

To establish a claim, the plaintiff must prove:

1. **A Defamatory Statement** – A false statement of fact that harms reputation.
2. **Of or Concerning the Plaintiff** – The statement must reasonably be understood as referring to the plaintiff.
3. **Published to a Third Party** – The statement must be communicated to at least one person other than the plaintiff.
4. **Causing Damage to Reputation** – The plaintiff's reputation is harmed as a result.

Examples

- **Libel Example**: A newspaper falsely reports that a local accountant embezzled client funds. Even though the accountant is innocent, the published statement harms his professional reputation.
- **Slander Example**: At a neighborhood meeting, a resident falsely claims a neighbor has been stealing packages. The spoken accusation spreads quickly and damages the neighbor's standing in the community.

Defamation per se

In certain situations, damages are **presumed** because the statements are so inherently damaging that harm to reputation is obvious. Categories include:

1. **Accusing the plaintiff of a crime**
   - Example: Falsely stating, "Maria was arrested for selling drugs," when no arrest occurred.
2. **Alleging the plaintiff has a loathsome disease**
   - Example: Falsely claiming that a co-worker has HIV.
3. **Statements injuring the plaintiff's trade, business, or profession**
   - Example: Falsely posting online that a surgeon "botches every operation."
4. **Accusing the plaintiff of serious sexual misconduct**
   - Example: Falsely saying a teacher engaged in inappropriate sexual conduct with students.

Because these accusations are considered inherently harmful, the plaintiff does not need to prove actual damages.

Privileges and Defenses

- **Truth** – An absolute defense: a true statement cannot be defamatory.
- **Absolute Privilege** – Complete protection for statements in judicial proceedings, legislative debate, or by high government officials.
- **Qualified Privilege** – Protection for good faith statements made in certain contexts (e.g., employment references), unless made with malice.
- **Opinion** – Pure opinion, as opposed to false assertions of fact, is generally protected.

Trade Libel / Product Disparagement

False statements about a business's products or services may constitute **trade libel** (or product disparagement).

- Example: A competitor falsely advertises that a rival's bottled water contains dangerous chemicals. If sales decline, the rival business may recover damages.

Public Officials/Public Figures: *New York Times v. Sullivan* (1964)

This landmark U.S. Supreme Court case reshaped defamation law, especially concerning public officials and public figures.

- **Background**: The *New York Times* published an advertisement criticizing how officials in Montgomery, Alabama, handled civil rights protests. Some factual errors appeared in the ad. L.B. Sullivan, a Montgomery city commissioner, sued for libel, claiming the statements harmed his reputation.
- **Ruling**: The Supreme Court held that when public officials sue for defamation, they must prove **actual malice**—that the defendant knew the statement was false or acted with reckless disregard for the truth.
- **Significance**: The case struck a balance between protecting reputations and safeguarding **freedom of the press and political speech**, making it harder for public officials and public figures to win defamation suits.

Invasion of Privacy

Rule and Definition

The **right of privacy**—the right "to be let alone"—did not receive judicial recognition until the twentieth century. Unlike defamation, which protects reputation, the right of privacy protects an individual's dignity, autonomy, and personal space. Courts and commentators generally recognize four distinct types of privacy interests:

Unified Scenario: The Case of Emily

Emily is a college student who recently won a local marathon. A media company, hoping to capitalize on her new recognition, takes a photo of her crossing the finish line. Without asking for permission, they use her image in an advertisement for a sports drink.

Meanwhile, a journalist trying to write a story about her success plants a hidden microphone in her apartment to capture private conversations.

Later, a gossip website publishes private details about Emily's medical struggles with anxiety, which had only been shared with her doctor.

Finally, another magazine runs a story with Emily's picture next to the headline, *"Local Athletes Caught in Doping Scandals"*. While the article makes no direct claim that Emily used drugs, the placement of her photo implies she is part of the scandal.

This single scenario illustrates how the different invasion of privacy torts can arise.

1. Appropriation of Name or Likeness

This occurs when someone uses another person's name, photograph, or likeness for commercial purposes without permission.

- **Emily Example**: The sports drink company used Emily's photo in an advertisement without her consent.
- **Case**: *Midler v. Ford Motor Co.* (1988) – Ford hired a singer to imitate Bette Midler's voice in a car commercial after she declined to participate. The court held that distinctive personal attributes (like Midler's voice) cannot be exploited without consent.

2. Intrusion upon Seclusion

This involves an intentional intrusion, physically or otherwise, into someone's private affairs in a way that would be highly offensive to a reasonable person.

- **Emily Example**: The journalist's hidden microphone in Emily's apartment violated her private space.
- **Case**: *Dietemann v. Time, Inc.* (1971) – Journalists entered a man's home under false pretenses with hidden recording devices. The court held that even when exposing wrongdoing, secretly intruding into a private home is unlawful.

3. Public Disclosure of Private Facts

This occurs when someone publicizes truthful but private information that would be highly offensive to a reasonable person and is not of legitimate public concern.

- **Emily Example**: The gossip site published details about Emily's medical struggles with anxiety, which were deeply personal and unrelated to her athletic achievements.
- **Case**: *Cox Broadcasting Corp. v. Cohn* (1975) – A TV station broadcast the name of a deceased rape victim, obtained from public records. While the Supreme Court ruled no liability existed because the information came from public documents, the case shows the tension between press freedom and privacy.

4. False Light

This involves publishing information that, while not technically defamatory, portrays someone in a misleading or highly offensive manner.

- **Emily Example**: The magazine's use of Emily's photo next to a doping scandal headline placed her in a misleading and offensive false light.
- **Case**: *Time, Inc. v. Hill* (1967) – *Life* magazine exaggerated the Hill family's experience as crime victims by comparing it to a violent play. The Court recognized false light as a privacy tort but required proof of actual malice when public interest was involved.

Summary

The right of privacy is not a single tort but a family of four related protections: **appropriation, intrusion, public disclosure, and false light**. The *Emily* scenario demonstrates how a single person's rights can be violated in multiple ways. These doctrines reflect the law's attempt to balance individual dignity and autonomy against freedom of speech, press, and commercial interests.

KEY TAKEAWAY

There are many types of **intentional torts**, and each protects different personal and societal interests. Some involve harm to the physical person (assault, battery, false imprisonment), others to property (trespass, nuisance, conversion), to reputation or feelings (defamation, invasion of privacy, intentional infliction of emotional distress), or to economic interests (intentional interference with contracts).

In every case, the plaintiff must prove that the defendant **intended the act that caused the harm**. Importantly, the law does not require the defendant to intend harm against a specific individual, nor does it require malice. As long as the harmful result is a direct consequence of the defendant's intentional actions, liability may follow.

EXERCISES

1. Name two kinds of intentional torts that could result in damage to a business firm's bottom line.
2. Name two kinds of intentional torts that are based on protection of a person's property.
3. Why are intentional torts more likely to result in a verdict not only for compensatory damages but also for punitive damages?

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6.3: Negligence

LEARNING OBJECTIVES

1. Understand how the duty of due care relates to negligence.
2. Distinguish between actual and proximate cause.
3. Explain the primary defenses to a claim of negligence.

Elements of Negligence

Introduction

Negligence is the most common tort in modern law. Unlike intentional torts, negligence arises from **careless conduct** that results in foreseeable harm to another. The essence of negligence is the failure to act as a reasonably prudent person would under the circumstances.

Consider the following scenario:

Scenario:
David and his girlfriend, Mary, are on their way to Napa, California, for a day of wine tasting. While driving along Interstate 80, Mary insists David watch a TikTok video she recently posted. David glances down at her phone and takes his eyes off the road. In that brief moment, David's car veers and strikes Sarah, who is lawfully crossing at a pedestrian overpass area. Sarah is severely injured.

Emergency responders place Sarah in an ambulance for transport to the nearest hospital. At an intersection, Kevin—whose own car had faulty brakes he had neglected for years due to financial struggles—fails to stop and collides with the ambulance carrying Sarah. Sarah dies from the injuries sustained in this second collision.

This tragic sequence highlights how negligence is analyzed through the four elements: **duty, breach, causation, and damages**.

Elements of Negligence

A plaintiff must establish four elements:

1. **Duty of Care** – The defendant owed a legal obligation to act reasonably.
2. **Breach of Duty** – The defendant failed to meet that standard of care.
3. **Causation** – The defendant's breach actually and proximately caused the harm.
4. **Damages** – The plaintiff suffered legally recognizable loss.

Duty of Care

In negligence law, the first question is whether the defendant owed the plaintiff a duty of care. **Duty refers to the legal obligation to act reasonably toward others to avoid causing foreseeable harm.** Courts apply the standard of the **reasonable person under the same or similar circumstances**—an objective measure that does not vary based on an individual's personal abilities, intentions, or financial struggles.

Application to the Napa Scenario

David owed a duty to everyone on the road—including Sarah, the pedestrian—to drive attentively, obey traffic signals, and properly maintain his vehicle. This duty existed regardless of his financial hardship in replacing the car's brakes. Similarly, Kevin owed a duty to yield to the ambulance, particularly when its lights and sirens clearly signaled an emergency. Both drivers were legally bound to act as reasonable drivers under the circumstances.

Heightened Duties

In some relationships, the law imposes a **higher duty of care** due to the risks involved or the trust placed in the defendant:

- **Common carriers** (e.g., bus drivers, airline pilots) are held to a heightened duty because passengers entrust their safety entirely to them.
  - *Example*: A city bus driver who texts while driving through traffic breaches a heightened duty because passengers depend completely on the driver's caution.
- **Caregivers and professionals** (e.g., daycare providers, doctors, accountants, attorneys) are judged against the knowledge, skill, and care of their profession rather than an ordinary person.
  - *Example*: A daycare provider who leaves children unsupervised on a playground has likely breached their heightened duty if a child is injured.
- **Special guides or instructors** may also be held to heightened standards.
  - *Example*: A professional rock climber taking beginners on a trip must ensure proper safety gear and instruction, given the extreme risks involved.

Landowners and Business Invitees

Landowners also owe duties to those who enter their property:

- **Business Invitees** (customers, clients, or others entering for the financial benefit of the owner) receive the highest protection. Landowners must **inspect, warn, and make safe** by correcting or warning of hazards they know or should have discovered through reasonable inspection.
  - *Example*: A grocery store that fails to clean up or warn of a spilled liquid in an aisle breaches its duty if a customer slips and falls.
- **Licensees** (social guests) and **trespassers** may be owed less, but owners still must avoid willful or wanton harm and, in some jurisdictions, warn of known hidden dangers.

Breach of the Duty of Care

Once a duty of care has been established, the next question is whether the defendant's conduct **fell below the required standard of care**. A **breach** occurs when a person or business fails to act as a reasonably prudent person would under the same or similar circumstances. The inquiry often turns on whether the defendant's actions—or failure to act—created an **unreasonable risk of harm** that could have been avoided with ordinary caution.

Because circumstances vary widely, breach is often a **question of fact for the jury**, rather than a pure question of law. Jurors are asked to weigh what a reasonably careful person would have done under the same situation.

Application to the Napa Scenario

- **David**: By taking his eyes off the road to watch Mary's TikTok video while driving, David failed to act as a reasonably prudent driver. Distracted driving is a clear breach because it creates foreseeable risks of harm to pedestrians, passengers, and other drivers.
- **Kevin**: Kevin knowingly operated his car with faulty brakes, which he had neglected to replace for years. Driving a vehicle in such a dangerous condition falls far below the standard of care expected of reasonable drivers. His defective brakes directly contributed to the catastrophic ambulance collision that killed Sarah.

Both drivers' conduct reflects a failure to use basic, ordinary caution. Their breaches were not unusual accidents but the result of avoidable, careless decisions.

Breach in Professional or Business Contexts

For professionals and businesses, breach is measured against the standards of the industry or profession, rather than ordinary personal judgment. Ignoring known hazards, failing to follow protocols, or disregarding widely accepted safety practices are strong indicators of breach.

- **Example**: A grocery store employee notices a spill in an aisle but chooses to finish restocking shelves instead of cleaning it up or posting a warning sign. If a customer slips and is injured, the store has likely breached its duty because a prudent business would have taken immediate steps to minimize the risk.

Key Point

Establishing breach requires showing that the defendant's conduct fell short of what a reasonable person—or, in some cases, a reasonable professional—would have done under the same circumstances. The more foreseeable the risk, the stronger the case for breach.

Causation: Actual Cause and Proximate Cause

Even if a duty of care exists and a breach has occurred, a negligence claim requires proof that the defendant's conduct caused the plaintiff's injury. Causation has two distinct components: **actual causation** and **proximate causation**.

Actual Causation (Cause in Fact)

Actual causation asks whether the harm would have occurred **"but for"** the defendant's conduct. If the injury would not have happened without the defendant's actions, then actual causation is satisfied. Courts may also apply the **substantial factor test** in cases where multiple causes combine to produce harm.

- **Scenario Application**:
  - But for **David's distraction** while watching Mary's TikTok video, Sarah would not have been struck as a pedestrian.
  - But for **Kevin's failure to maintain his brakes**, Sarah would not have died in the subsequent ambulance collision.

Both acts were actual causes of Sarah's injuries and eventual death.

Proximate Causation (Legal Cause)

Proximate cause limits liability to those harms that are reasonably foreseeable consequences of the defendant's actions. Even if actual causation is shown, the law does not hold defendants liable for every ripple effect of their conduct. Courts apply the **foreseeability test**: *Was the type of harm that occurred a foreseeable result of the defendant's negligence?*

- **Scenario Application**:
  - It is foreseeable that distracted driving could cause a collision with a pedestrian.
  - It is foreseeable that driving with faulty brakes could result in a catastrophic crash, even with an emergency vehicle.
  - By contrast, if Sarah had died because a bolt of lightning struck the ambulance during transport, that result would not be foreseeable and would break the chain of causation.

Case Illustration: *Palsgraf v. Long Island Railroad Co.* (1928)

Facts:
Mrs. Palsgraf was standing on a train platform owned by the Long Island Railroad. A man carrying a small package tried to board a moving train. Railroad guards attempted to help him on—one pulling him up, another pushing from behind. In the process, the man dropped the package, which contained fireworks. The fireworks exploded, causing a large shockwave. At the far end of the platform, the blast knocked over a set of scales, which fell and injured Mrs. Palsgraf.

Issue:
Could the railroad be held liable for Mrs. Palsgraf's injuries, even though she was far removed from the immediate accident?

Holding:
The New York Court of Appeals, in an opinion by Judge Cardozo, held that the railroad was **not liable**. Although the guards' conduct was arguably negligent toward the man with the package, it was not negligent toward Mrs. Palsgraf because her injury was not a **reasonably foreseeable consequence** of helping a passenger board a train.

Reasoning:
Cardozo emphasized that negligence is relational: it is a duty owed to those within the **zone of foreseeable danger**. Since the guards could not reasonably foresee that helping a man with a small package would cause scales to fall and injure a distant bystander, proximate cause was not satisfied.

Significance:
Palsgraf is the classic case on **proximate cause**, teaching that negligence liability is not limitless. Even if a breach sets off a chain of events, courts draw boundaries at injuries that are too remote or unforeseeable.

Key Point

- **Actual Cause**: Proven by the **"but for" test**—would the harm have occurred without the defendant's negligence?
- **Proximate Cause**: Proven by the **foreseeability test**—was the type of harm a reasonably foreseeable result of the negligence?

Together, actual and proximate causation ensure that defendants are held liable only for harms both factually caused by their actions and reasonably foreseeable.

Damages

The final element of negligence is proof of **actual damages**. Even if duty, breach, and causation are established, a plaintiff cannot recover without demonstrating a legally recognized injury. Damages provide the link between the defendant's wrongful conduct and the plaintiff's loss, ensuring that the legal system compensates only for **real harm** rather than hypothetical or speculative injuries.

Types of Damages in Negligence

1. **Compensatory Damages**
   - Designed to make the plaintiff "whole."
   - Includes both **economic losses** (medical expenses, lost wages, property damage) and **noneconomic losses** (pain and suffering, emotional distress, loss of consortium).
   - *Example from Scenario*: Sarah's estate could recover for her medical bills, ambulance costs, lost earnings, and the pain and suffering she endured before death. Her family might also claim wrongful death damages for lost financial support and companionship.
2. **Punitive Damages**
   - Awarded rarely in negligence cases, only when conduct rises to the level of **willful, malicious, or reckless disregard** for safety.
   - Intended not to compensate the plaintiff but to **punish the defendant** and deter similar misconduct.
   - *Example*: If it were shown that Kevin knowingly disabled his car's brake warning system to avoid costly repairs, a court might consider punitive damages because such conduct shows reckless indifference to human life.
3. **Nominal Damages**
   - A token amount awarded when a legal wrong occurred but no substantial loss can be proven.
   - Rare in negligence, since actual injury is usually required, but possible where breach is clear yet harm is absent.
   - *Scenario*: A driver, while backing out of a parking space, carelessly brushes against a pedestrian's jacket. The pedestrian is startled but suffers no physical injury, no medical costs, and no financial loss. A court might award **nominal damages** (such as $1) to recognize that a legal wrong occurred, even though no compensable injury resulted.

Why Damages Matter

Negligence law is not about punishing careless conduct in the abstract—it is about **compensating victims for harm suffered**. Without damages, a negligence claim fails, even if the defendant clearly breached a duty.

The Plaintiff's Proof and Presumptions in Negligence

In negligence cases, the **plaintiff bears the burden of proof**. This means the plaintiff must establish that:

1. The defendant engaged in the conduct alleged to be negligent.
2. The circumstances made that conduct unreasonable.
3. The defendant's breach caused the plaintiff's injury.
4. The injury resulted in legally recognizable damages.

These issues are generally resolved by a **jury**, which evaluates the facts and determines whether the defendant's conduct fell below the standard of care.

Direct vs. Circumstantial Evidence

Direct proof—such as eyewitness testimony or video footage—is ideal but not always available. Frequently, plaintiffs must rely on **circumstantial evidence** (indirect evidence from which negligence can be inferred). Circumstantial evidence can be highly persuasive: muddy footprints leaving a building may show that someone was inside, even if no one saw them enter.

The Doctrine of Res Ipsa Loquitur

Because direct proof is often difficult to obtain, courts recognize the doctrine of **res ipsa loquitur** ("the thing speaks for itself"). This doctrine allows a jury to **infer negligence** from the mere occurrence of certain types of accidents, shifting the burden to the defendant to prove that they exercised due care.

The classic requirements for res ipsa loquitur are:

1. The type of accident ordinarily does not occur without negligence.
2. The instrumentality that caused the harm was under the defendant's exclusive control.
3. The plaintiff did not contribute to the accident.

- **Case Example: *Scott v. London & St. Katherine Docks Co.* (1865)**
  A worker was struck by falling bags of sugar from a warehouse. The court held that such an accident ordinarily would not happen without negligence. Since the bags were under the control of the defendant, and the plaintiff did nothing to cause the accident, the jury could infer negligence.

- **Medical Example**: A patient undergoes routine surgery and awakens with a severe burn on her arm. Because she was unconscious, she cannot explain what happened. Since surgical burns do not normally occur without negligence, and the patient contributed nothing, res ipsa loquitur permits the court to infer negligence by the hospital staff unless they provide a credible explanation.

Application to the Napa Scenario

Suppose Sarah's ambulance crashed because one of its wheels suddenly detached during transport. Sarah's estate might invoke **res ipsa loquitur** to argue negligence against the ambulance company because:

1. Ambulance wheels do not ordinarily come off without poor maintenance.
2. The ambulance and its equipment were under the company's control.
3. Sarah, as a patient, did not contribute to the harm.

In this situation, the burden would shift to the ambulance company to show that the wheel came off due to an unforeseeable event (e.g., sabotage or a latent defect in the part) rather than negligence.

Key Point

Because negligence often occurs in private or technical circumstances beyond the plaintiff's knowledge, doctrines like **res ipsa loquitur** prevent injustice by allowing juries to infer fault where the facts strongly suggest negligence. Still, the plaintiff always

carries the initial burden of producing enough evidence to show that negligence is the most reasonable explanation for the harm.

Defenses to Negligence

Even if a plaintiff successfully proves all four elements of negligence—duty, breach, causation, and damages—the defendant may still avoid or reduce liability through one of several defenses. These defenses are designed to balance fairness: the law does not want to impose liability where the plaintiff also contributed to the harm, knowingly assumed the risk, or where a natural event—not the defendant—was the true cause of injury.

Superseding Cause and Intervening Act

Even when a plaintiff proves duty, breach, causation, and damages, a defendant may avoid liability if an **intervening act** breaks the chain of causation. Courts distinguish between **intervening acts** (foreseeable events that do not relieve the original defendant of liability) and **superseding causes** (extraordinary, unforeseeable events that cut off liability).

The key inquiry is **foreseeability**:

- If the subsequent act was reasonably foreseeable, the original defendant remains liable, often alongside the second wrongdoer.
- If the subsequent act was highly unusual or extraordinary, it is deemed a superseding cause, severing the causal link.

Intervening Act

An intervening act is one that occurs after the defendant's negligent conduct but is sufficiently foreseeable that liability continues.

- **Scenario Application**:
  - David struck Sarah while distracted by Mary's TikTok video.
  - Kevin then crashed into the ambulance carrying Sarah because his brakes were faulty.
  - Kevin's negligence was an **intervening act**, but not unforeseeable. Collisions involving inattentive or poorly maintained drivers are foreseeable risks when someone is injured and transported by ambulance. Thus, David may remain liable for Sarah's death alongside Kevin.

Superseding Cause

A superseding cause is an intervening act so extraordinary or unforeseeable that it breaks the chain of causation, relieving the original defendant of liability.

- **Scenario Application**:
  - Suppose instead that, while Sarah was in the ambulance, a freak earthquake caused a light pole to fall directly onto the ambulance, killing her.
  - This event is extraordinary and unrelated to the risks created by David's distraction. The earthquake would be considered a **superseding cause**, cutting off David's liability for Sarah's death (though he would still be liable for her initial injuries).

Key Point

- **Intervening Act**: A later event that is foreseeable (e.g., Kevin's faulty brakes) → liability continues.
- **Superseding Cause**: A later event that is extraordinary and unforeseeable (e.g., earthquake crushing the ambulance) → liability cut off.

By distinguishing between intervening and superseding events, courts ensure that defendants are not unfairly held responsible for consequences that extend far beyond the foreseeable risks of their actions.

Contributory and Comparative Negligence

Historically, under the old **contributory negligence** rule, if the plaintiff was even 1% at fault, recovery was completely barred. For example, if Sarah had been only slightly negligent in contributing to the accident on I-80, she would have recovered **nothing**, no matter how reckless Kevin had been. Because this rule was so harsh, most states—including **California**—have replaced it with comparative negligence systems.

It is important to remember that, **just like any negligence claim**, the plaintiff must first prove all **four elements of negligence** against the defendant:

1. **Duty** – Kevin owed Sarah and other drivers a duty to drive safely.
2. **Breach** – Kevin breached that duty by being distracted by Mary's TikTok and by failing to maintain his brakes.
3. **Causation** – Kevin's breach was both the factual and proximate cause of Sarah's injuries.
4. **Damages** – Sarah suffered serious harm, ultimately resulting in her death.

Only after the plaintiff has met this burden does **contributory or comparative negligence** come into play to determine whether, and to what extent, recovery is reduced.

Pure Comparative Negligence (California's Rule)

In California, a plaintiff can recover damages even if they are mostly at fault. Recovery is simply reduced by their percentage of fault.

- *Example*: If Sarah's estate proves $1,000,000 in damages, but the jury finds her 30% at fault (for speeding), she would still recover $700,000 from Kevin.

Modified Comparative Negligence (Majority of States)

In many states, a plaintiff can only recover if they are less than 50% (or in some states, 51%) at fault. If their share of fault meets or exceeds that threshold, recovery is barred entirely.

Assumption of Risk

Risk of injury is a part of everyday life, but the law does not allow plaintiffs to recover simply because they encountered a risk and suffered harm. When a person **knowingly and voluntarily accepts a risk**, the law may bar recovery through the defense of **assumption of risk**. In such cases, the plaintiff must bear the consequences of their choice.

Types of Assumption of Risk

1. **Express Agreement** – The plaintiff formally agrees to waive liability before entering a risky situation.
    - *Example*: "You can borrow my car if you agree not to sue me if the brakes fail, because they're worn and I haven't had a chance to replace them."
2. **Implied by Relationship** – The plaintiff voluntarily participates in an activity where certain risks are obvious and inherent.
    - *Example*: A baseball fan struck by a foul ball at a game generally cannot sue, as attending carries the known risk of foul balls.
3. **Implied by Conduct** – The plaintiff knowingly proceeds in the face of a known danger created by the defendant's negligence.
    - *Example*: A passenger who gets into a car with a driver she knows is intoxicated may be found to have assumed the risk of an accident.

Subjective vs. Objective Knowledge

A key question is whether the plaintiff **actually knew** of the risk (subjective test) or whether they **should have known** under an objective community standard. Courts may hold that risks that are obvious to a reasonable person cannot be denied simply because the plaintiff claims not to have appreciated them. However, when the plaintiff has no reasonable alternative—such as a tenant forced to use a negligently unlit exit—assumption of risk will not apply.

Napa Scenario Application

In the Napa case:

- **Sarah** – Sarah did not knowingly assume any risk. She was struck first by David (distracted driving) and later fatally injured when Kevin's faulty brakes caused the ambulance crash. She was an innocent motorist and patient; therefore, assumption of risk does not apply to her.
- **David and Mary** – Mary, as a passenger, could potentially raise issues of assumption of risk if she knowingly distracted David while driving. If she encouraged him to look at TikTok videos while on the highway, a defense attorney might argue she voluntarily created or accepted the risk of harm from his distraction. Still, Sarah's estate would not be affected by this; it would go more to Mary's own potential claims.
- **Kevin** – Had Kevin offered a ride to a friend who knew his brakes had been defective for years and got in the car anyway, that passenger could be barred from recovery under assumption of risk. But since Sarah was in an ambulance at the time, she did not assume Kevin's risk.

Act of God

Technically, the rule that no one is responsible for an **"act of God"** (sometimes called *force majeure*) is not an excuse but a defense based on a lack of causation. If a purely natural force caused the harm, then the defendant was not negligent in the first place.

For example, a marina tasked with safeguarding boats moored at its dock is not liable if a sudden and violent storm—against which no precautions could be effective—destroys the vessels. The harm is attributed to nature, not to any failure by the marina.

However, if it is **foreseeable** that harm could result from a negligent condition triggered by a natural event, liability may still follow.

- **Case Example – *Johnson v. Kosmos Portland Cement Co.* (1933):**
  A company failed to remove residual explosive gas from an oil barge. Lightning struck, ignited the gas, and injured several workmen. The court held the company liable because its negligence lay in leaving the gas present—it was foreseeable that *some* chance occurrence (lightning, sparks, or other ignition) might trigger an explosion.

Napa Scenario Application

In the Napa case, Sarah was first struck by David's distracted driving and then fatally injured when Kevin's faulty brakes caused an ambulance crash.

- If instead of Kevin's negligence, the ambulance had been struck by a **massive earthquake** that caused vehicles to collide on I-80, the defendants might invoke the **act of God defense**. The earthquake would be seen as the true cause of the harm, breaking the chain of causation.
- But if Kevin's poorly maintained brakes failed during a heavy rainstorm, he could not claim "act of God." Rain is foreseeable, and his negligence in failing to maintain the brakes combined with the weather to cause the crash.

Vicarious Liability

In some situations, a person or organization may be held legally responsible for the wrongful acts of another, even if they did not personally commit the act. This principle is known as **vicarious liability**.

The most common application arises in the **employer–employee relationship**, where an employer can be held liable for the negligent acts of an employee if those acts were committed within the **scope of employment**. This doctrine, often expressed in the Latin phrase *respondeat superior* ("let the master answer"), reflects the idea that employers are in the best position to:

1. Spread the cost of accidents through insurance, and
2. Implement training and policies to reduce risks in the future.

Importantly, vicarious liability does not mean the employee is free from responsibility—**both the employee and the employer may be held liable**. The key inquiry is whether the employee's wrongful conduct occurred while carrying out job-related duties,

rather than acting solely for personal reasons.

Traditional Example

A delivery driver employed by a shipping company causes an accident while making deliveries along his assigned route. Because the driver was acting within the **scope of employment**, the shipping company can be held vicariously liable for the injuries caused, even though the company itself did not directly commit the negligent act.

Napa Scenario Application

In the Napa scenario, Sarah was first struck by David (distracted by Mary's TikTok video) and later fatally injured when the ambulance carrying her collided with Kevin's car due to his faulty brakes.

If the **ambulance driver** had been negligent—for example, by speeding recklessly through a red light without ensuring the intersection was clear—the private ambulance company could be held **vicariously liable** for the driver's negligence. Because the driver was acting within the scope of employment (transporting a patient to the hospital), the company shares legal responsibility for the harm caused.

By contrast, **Kevin's liability is personal**, because his brake failure was due to his own failure to maintain his vehicle. There is no employer involved in his case, so vicarious liability does not apply to him.

KEY TAKEAWAY

The most common tort claim is based on **negligence**. To succeed in a negligence claim, the plaintiff must establish by a **preponderance of the evidence** that:

1. The defendant owed a **duty of due care**,
2. The defendant **breached** that duty,
3. The breach was both the **actual cause** and the **proximate cause** of the plaintiff's harm, and
4. The plaintiff suffered **measurable damages**, which can be compensated in money.

Negligence can sometimes be **imputed to another party**. For example, under the doctrine of *respondeat superior*, an employer may be held liable for the negligent acts of its employee committed within the scope of employment. Similarly, the owner of a car who lends it to another person may be liable if that driver negligently causes injury.

Defendants may raise several **defenses** to negligence claims. These include **assumption of risk** (where the plaintiff knowingly accepts a risk of harm) and **comparative negligence** (where damages are reduced according to the plaintiff's share of fault). In the few jurisdictions that still apply **contributory negligence**, any negligence on the part of the plaintiff will completely bar recovery, no matter how slight.

EXERCISES

1. Explain the difference between comparative negligence and contributory negligence.
2. How is actual cause different from probable cause?
3. What is an example of assumption of risk?
4. How does res ipsa loquitur help a plaintiff establish a case of negligence?

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6.4: Strict Liability and Product Liability

LEARNING OBJECTIVES

1. Explain the historical basis of strict liability, including liability for animals and ultrahazardous activities.
2. Describe how strict liability applies to modern product liability cases.
3. Differentiate between product liability claims based on negligence and those based on strict liability.
4. Identify and apply the elements of strict product liability under Restatement (Second) of Torts § 402A (1964).
5. Distinguish among the three types of product defects: design defects, manufacturing defects, and inadequate warnings.
6. Understand the doctrine of market-share liability and its application in cases involving fungible products.
7. Analyze the major defenses to product liability claims, including preemption, assumption of the risk, and comparative negligence.
8. Evaluate how strict liability balances consumer protection with fairness to manufacturers, sellers, and distributors.

Strict Liability and Product Liability

Introduction

Up to this point, tort liability has generally required some measure of fault—either intentional wrongdoing or negligence, defined as a failure to act with reasonable care. But the law has long recognized that fault is not always necessary for liability. Some activities and relationships carry such inherent risks that those who engage in them must bear responsibility for the harm they cause, regardless of the precautions taken. This principle is known as **strict liability.**

Historically, strict liability arose in two main areas: (1) ownership of animals and (2) ultrahazardous or abnormally dangerous activities, such as blasting or storing toxic chemicals. In the twentieth century, courts extended strict liability to **defective products**, reasoning that manufacturers are in the best position to spread the costs of accidents and protect consumers from hidden risks. Together, these doctrines form the backbone of modern strict liability law.

Historical Basis of Strict Liability: Animals and Ultrahazardous Activities

Ultrahazardous Activities

Those who engage in inherently dangerous activities—such as using explosives, storing hazardous materials, or transporting flammable chemicals—are strictly liable for any harm that results, even if they exercised all possible care. The rationale is simple: when activities pose a high degree of risk that cannot be eliminated through reasonable precautions, the party creating the risk must bear the burden of resulting injuries.

Animals

- **Wild Animals** – Owners of inherently dangerous wild animals (e.g., tigers, bears, venomous snakes) are strictly liable for injuries they cause, regardless of precautions.
- **Domestic Animals** – Owners are liable once an animal is known to have a "dangerous propensity" to harm others. Under the traditional common law "one-bite rule," liability arose only after the first known bite.

  California, however, has **abolished the one-bite rule.** Under **Civil Code § 3342**, a dog owner is strictly liable for *any* bite, even the first, without the need to prove prior knowledge of dangerous behavior.

Case in Point – *People v. Knoller* (2007), 41 Cal.4th 139

- **Facts**: In January 2001, Diane Whipple, a lacrosse coach, was attacked and killed by two Presa Canario dogs in the hallway of her San Francisco apartment building. The dogs, owned by clients of two lawyers, Marjorie Knoller and Robert Noel, had a

history of aggressive behavior. Neighbors repeatedly warned of the danger.
- **Legal Proceedings**: Knoller was charged with second-degree murder, manslaughter, and keeping a mischievous animal that caused death. The California Supreme Court held that second-degree murder was appropriate when a defendant acts with *conscious disregard for human life*. Knoller was ultimately convicted and sentenced to prison.
- **Significance**: The case illustrates that California imposes not only civil liability under § 3342 but also potential **criminal liability, including murder**, if an owner recklessly disregards the danger their animal poses.

Product Liability

Product liability extends strict liability principles to manufactured goods. Manufacturers, distributors, retailers, and others in the chain of commerce may be held responsible for injuries caused by defective products. A plaintiff may bring a claim under either **negligence** or **strict liability** theories.

Product Liability Based on Negligence

In negligence-based product liability, the plaintiff must prove the traditional elements of negligence: **duty, breach, causation, and damages.**

- **Duty**: Manufacturers and sellers must exercise reasonable care in:
  - Designing products safely.
  - Selecting appropriate materials.
  - Maintaining safe production processes.
  - Conducting adequate testing and quality control.
  - Providing proper instructions and warnings about foreseeable risks.
- **Breach**: A failure in any of these duties—such as using defective materials, skipping quality checks, or failing to warn—may constitute a breach.
- **Causation**: The plaintiff must show both **actual cause** ("but for" the defect, the injury would not have occurred) and **proximate cause** (the harm was a foreseeable result of the defect).
- **Damages**: The plaintiff must prove actual injury to person or property.

Privity of Contract Not Required

Historically, under contract law, only direct purchasers (those "in privity" with the seller) could sue. Today, courts have eliminated this barrier. Bystanders, family members, or anyone injured by a defective product may sue.

Example: If a defective tire explodes and injures a pedestrian, the pedestrian can bring a product liability claim against the tire manufacturer—even though they never purchased the tire.

Strict Product Liability

Because proving negligence can be difficult, modern courts developed **strict liability for defective products.** This principle, expressed in the **Restatement (Second) of Torts § 402A (1964),** holds sellers liable for placing defective, unreasonably dangerous products into the market—even if they exercised all possible care.

Elements of Strict Product Liability

To recover, the plaintiff must prove:

1. The product was defective when sold.
2. The defendant was in the business of selling or distributing the product.
3. The defect made the product unreasonably dangerous.
4. The plaintiff suffered physical harm to person or property.
5. The defect was the proximate cause of the harm.
6. The product was not substantially altered after leaving the seller's control.

This framework ensures that liability arises from the defective condition of the product, not from the manufacturer's level of care.

Types of Product Defects

1. **Design Defects**
   - Occur when the product is manufactured as intended, but the design itself is unsafe.
   - *Example*: An SUV with a high center of gravity prone to rollovers.
   - *Case*: *Grimshaw v. Ford Motor Co.* (Cal. App. 1981) – the Ford Pinto case, where the fuel tank design created a high risk of explosion in rear-end collisions.
2. **Manufacturing Defects**
   - Arise when the design is safe, but something goes wrong in production.
   - *Example*: A bicycle frame fails because the wrong grade of steel was used in a batch.
   - *Case*: *Escola v. Coca Cola Bottling Co.* (Cal. 1944) – exploding Coke bottle injured a waitress due to manufacturing flaws.
3. **Inadequate Warnings (Failure to Warn)**
   - Liability arises when products lack sufficient instructions or warnings about non-obvious risks.
   - *Example*: A prescription drug sold without a warning about known side effects.
   - *Case*: *Liebeck v. McDonald's Restaurants* (1994) – plaintiff suffered third-degree burns from excessively hot coffee served without adequate warning.

Market-Share Liability

In some cases, plaintiffs cannot identify the specific manufacturer of a harmful product, especially when the product is fungible (identical across manufacturers). To prevent injustice, courts developed **market-share liability.**

- **Key Case – *Sindell v. Abbott Laboratories* (Cal. 1980):**
  Plaintiffs alleged cancer caused by DES, a drug made by hundreds of companies. Unable to identify which manufacturer produced the pills their mothers took, plaintiffs sued multiple companies. The California Supreme Court allowed recovery based on each defendant's share of the national DES market.

- **Significance**: Manufacturers cannot escape liability simply because their products are indistinguishable from others.
- **Example**: Sarah develops illness after taking a generic drug made by many pharmaceutical companies. Since the drug is identical across brands, she sues multiple manufacturers under market-share liability. Each pays damages according to its share of the market.
- **Limits**:
  - Applies mainly to fungible products.
  - Not usually extended to unique or traceable products.
  - Some jurisdictions outside California reject or limit this doctrine.

Defenses to Product Liability

Even when a plaintiff establishes negligence or strict liability, defendants may raise defenses to reduce or avoid liability. Common defenses include **preemption, assumption of the risk, and comparative negligence.**

Preemption

Preemption occurs when federal law overrides or limits state law claims. If federal regulations set comprehensive safety standards for a product, manufacturers may argue that state tort claims are barred because compliance with both federal and state law would be impossible, or because Congress intended federal law to control exclusively.

- *Example*: A medical device approved by the U.S. Food and Drug Administration (FDA) under rigorous federal standards may be shielded from certain state-law defect claims.

Assumption of the Risk

Assumption of the risk applies when the plaintiff knowingly and voluntarily uses a product despite awareness of its dangers.

- *Example*: A consumer ignores clear warnings to wear safety goggles while using a chainsaw. If injured, the manufacturer can argue assumption of the risk.

Comparative Negligence

In some states, including California, product liability cases may also involve **comparative negligence.** This doctrine reduces the plaintiff's recovery in proportion to their share of fault.

- *Example*: A driver is injured when their car's airbags fail to deploy in a crash. Investigation shows the airbags were defectively designed, but also that the driver was texting at the time of the accident. If the jury assigns the driver 20% of the fault, the damages awarded will be reduced by 20%.

KEY TAKEAWAY

Strict liability reflects a policy choice: those who introduce risk into society should bear the cost of resulting harm. Historically, this principle applied to wild animals, domestic animals with dangerous propensities, and ultrahazardous activities. In modern law, it extends to defective products.

Product liability may rest on **negligence** (focusing on the manufacturer's conduct), **strict liability** (focusing on the product itself), or doctrines such as **market-share liability** (shifting the burden when causation is difficult to prove).

Defendants, however, are not without recourse. **Preemption** shields manufacturers when federal law controls product safety, **assumption of the risk** prevents recovery when plaintiffs knowingly disregard product warnings, and **comparative negligence** apportions fault between the manufacturer and the consumer. Strict liability, therefore, balances consumer protection with fairness to defendants.

EXERCISES

1. Someone says, "Strict liability means that you're liable for whatever you make, no matter what the consumer does with your product. It's a crazy system." Respond to and refute this statement.
2. What is the essential difference between strict liability torts and negligent torts? Should the US legal system even allow strict liability torts? What reasons seem persuasive to you?

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6.5: Cases

Intentional Torts: False Imprisonment

Lester v. Albers Super Markets, Inc.

94 Ohio App. 313, 114 N.E.2d 529 (Ohio 1952)

Facts: The plaintiff, carrying a bag of rolls purchased at another store, entered the defendant's grocery store to buy some canned fruit. Seeing her bus outside, she stepped out of line and put the can on the counter. The store manager intercepted her and repeatedly demanded that she submit the bag to be searched. Finally she acquiesced; he looked inside and said she could go. She testified that several people witnessed the scene, which lasted about fifteen minutes, and that she was humiliated. The jury awarded her $800. She also testified that no one laid a hand on her or made a move to restrain her from leaving by any one of numerous exits.

* * *

MATTHEWS, JUDGE.

As we view the record, it raises the fundamental question of what is imprisonment. Before any need for a determination of illegality arises there must be proof of imprisonment. In 35 Corpus Juris Secundum (C.J.S.), False Imprisonment, § II, pages 512–13, it is said: "Submission to the mere verbal direction of another, unaccompanied by force or by threats of any character, cannot constitute a false imprisonment, and there is no false imprisonment where an employer interviewing an employee declines to terminate the interview if no force or threat of force is used and false imprisonment may not be predicated on a person's unfounded belief that he was restrained."

Many cases are cited in support of the text.

* * *

In Fenn v. Kroger Grocery & Baking Co., Mo. Sup., 209 S.W. 885, 887, the court said:

A case was not made out for false arrest. The plaintiff said she was intercepted as she started to leave the store; that Mr. Krause stood where she could not pass him in going out. She does not say that he made any attempt to intercept her. She says he escorted her back to the desk, that he asked her to let him see the change.

...She does not say that she went unwillingly...Evidence is wholly lacking to show that she was detained by force or threats. It was probably a disagreeable experience, a humiliating one to her, but she came out victorious and was allowed to go when she desired with the assurance of Mr. Krause that it was all right. The demurrer to the evidence on both counts was properly sustained.

The result of the cases is epitomized in 22 Am.Jur. 368, as follows:

A customer or patron who apparently has not paid for what he has received may be detained for a reasonable time to investigate the circumstances, but upon payment of the demand, he has the unqualified right to leave the premises without restraint, so far as the proprietor is concerned, and it is false imprisonment for a private individual to detain one for an unreasonable time, or under unreasonable circumstances, for the purpose of investigating a dispute over the payment of a bill alleged to be owed by the person detained for cash services.

* * *

For these reasons, the judgment is reversed and final judgment entered for the defendant-appellant.

CASE QUESTIONS

1. The court begins by saying what false imprisonment is not. What is the legal definition of false imprisonment?

2. What kinds of detention are permissible for a store to use in accosting those that may have been shoplifting?
3. Jody broke up with Jeremy and refused to talk to him. Jeremy saw Jody get into her car near the business school and parked right behind her so she could not move. He then stood next to the driver's window for fifteen minutes, begging Jody to talk to him. She kept saying, "No, let me leave!" Has Jeremy committed the tort of false imprisonment?

Negligence: Duty of Due Care

Whitlock v. University of Denver

744 P.2d 54 (Supreme Court of Colorado1987)

On June 19, 1978, at approximately 10:00 p.m., plaintiff Oscar Whitlock suffered a paralyzing injury while attempting to complete a one-and-three-quarters front flip on a trampoline. The injury rendered him a quadriplegic. The trampoline was owned by the Beta Theta Pi fraternity (the Beta house) and was situated on the front yard of the fraternity premises, located on the University campus. At the time of his injury, Whitlock was twenty years old, attended the University of Denver, and was a member of the Beta house, where he held the office of acting house manager. The property on which the Beta house was located was leased to the local chapter house association of the Beta Theta Pi fraternity by the defendant University of Denver.

Whitlock had extensive experience jumping on trampolines. He began using trampolines in junior high school and continued to do so during his brief tenure as a cadet at the United States Military Academy at West Point, where he learned to execute the one-and-three-quarters front flip. Whitlock testified that he utilized the trampoline at West Point every other day for a period of two months. He began jumping on the trampoline owned by the Beta house in September of 1977. Whitlock recounted that in the fall and spring prior to the date of his injury, he jumped on the trampoline almost daily. He testified further that prior to the date of his injury, he had successfully executed the one-and-three-quarters front flip between seventy-five and one hundred times.

During the evening of June 18 and early morning of June 19, 1978, Whitlock attended a party at the Beta house, where he drank beer, vodka and scotch until 2:00 a.m. Whitlock then retired and did not awaken until 2:00 p.m. on June 19. He testified that he jumped on the trampoline between 2:00 p.m. and 4:00 p.m., and again at 7:00 p.m. At 10:00 p.m., the time of the injury, there again was a party in progress at the Beta house, and Whitlock was using the trampoline with only the illumination from the windows of the fraternity house, the outside light above the front door of the house, and two street lights in the area. As Whitlock attempted to perform the one-and-three-quarters front flip, he landed on the back of his head, causing his neck to break.

Whitlock brought suit against the manufacturer and seller of the trampoline, the University, the Beta Theta Pi fraternity and its local chapter, and certain individuals in their capacities as representatives of the Beta Theta Pi organizations. Whitlock reached settlements with all of the named defendants except the University, so only the negligence action against the University proceeded to trial. The jury returned a verdict in favor of Whitlock, assessing his total damages at $ 7,300,000. The jury attributed twenty-eight percent of causal negligence to the conduct of Whitlock and seventy-two percent of causal negligence to the conduct of the University. The trial court accordingly reduced the amount of the award against the University to $ 5,256,000.

The University moved for judgment notwithstanding the verdict, or, in the alternative, a new trial. The trial court granted the motion for judgment notwithstanding the verdict, holding that as a matter of law, no reasonable jury could have found that the University was more negligent than Whitlock, and that the jury's monetary award was the result of sympathy, passion or prejudice.

A panel of the court of appeals reversed...by a divided vote. *Whitlock v. University of Denver,* 712 P.2d 1072 (Colo. App. 1985). The court of appeals held that the University owed Whitlock a duty of due care to remove the trampoline from the fraternity premises or to supervise its use....The case was remanded to the trial court with orders to reinstate the verdict and damages as determined by the jury. The University then petitioned for certiorari review, and we granted that petition.

II.

A negligence claim must fail if based on circumstances for which the law imposes no duty of care upon the defendant for the benefit of the plaintiff. [Citations] Therefore, if Whitlock's judgment against the University is to be upheld, it must first be determined that the University owed a duty of care to take reasonable measures to protect him against the injury that he sustained.

Whether a particular defendant owes a legal duty to a particular plaintiff is a question of law. [Citations] "The court determines, as a matter of law, the existence and scope of the duty—that is, whether the plaintiff's interest that has been infringed by the conduct

of the defendant is entitled to legal protection." [Citations] In *Smith v. City & County of Denver,* 726 P.2d 1125 (Colo. 1986), we set forth several factors to be considered in determining the existence of duty in a particular case:

Whether the law should impose a duty requires consideration of many factors including, for example, the risk involved, the foreseeability and likelihood of injury as weighed against the social utility of the actor's conduct, the magnitude of the burden of guarding against injury or harm, and the consequences of placing the burden upon the actor.

...A court's conclusion that a duty does or does not exist is "an expression of the sum total of those considerations of policy which lead the law to say that the plaintiff is [or is not] entitled to protection."

...

We believe that the fact that the University is charged with negligent failure to act rather than negligent affirmative action is a critical factor that strongly militates against imposition of a duty on the University under the facts of this case. In determining whether a defendant owes a duty to a particular plaintiff, the law has long recognized a distinction between action and a failure to act—"that is to say, between active misconduct working positive injury to others [misfeasance] and passive inaction or a failure to take steps to protect them from harm [nonfeasance]." W. Keeton, § 56, at 373. Liability for nonfeasance was slow to receive recognition in the law. "The reason for the distinction may be said to lie in the fact that by 'misfeasance' the defendant has created a new risk of harm to the plaintiff, while by 'nonfeasance' he has at least made his situation no worse, and has merely failed to benefit him by interfering in his affairs." *Id.* The *Restatement (Second) of Torts* § 314 (1965) summarizes the law on this point as follows:

The fact that an actor realizes or should realize that action on his part is necessary for another's aid or protection does not of itself impose upon him a duty to take such action.

Imposition of a duty in all such cases would simply not meet the test of fairness under contemporary standards.

In nonfeasance cases the existence of a duty has been recognized only during the last century in situations involving a limited group of special relationships between parties. Such special relationships are predicated on "some definite relation between the parties, of such a character that social policy justifies the imposition of a duty to act." W. Keeton, § 56, at 374. Special relationships that have been recognized by various courts for the purpose of imposition of a duty of care include common carrier/passenger, innkeeper/guest, possessor of land/invited entrant, employer/employee, parent/child, and hospital/patient. *See Restatement (Second) of Torts* § 314 A (1965); 3 Harper and James, § 18.6, at 722–23. The authors of the *Restatement (Second) of Torts* § 314 A, comment b (1965), state that "the law appears...to be working slowly toward a recognition of the duty to aid or protect in any relation of dependence or of mutual dependence."

...

III.

The present case involves the alleged negligent failure to act, rather than negligent action. The plaintiff does not complain of any affirmative action taken by the University, but asserts instead that the University owed to Whitlock the duty to assure that the fraternity's trampoline was used only under supervised conditions comparable to those in a gymnasium class, or in the alternative to cause the trampoline to be removed from the front lawn of the Beta house....If such a duty is to be recognized, it must be grounded on a special relationship between the University and Whitlock. According to the evidence, there are only two possible sources of a special relationship out of which such a duty could arise in this case: the status of Whitlock as a student at the University, and the lease between the University and the fraternity of which Whitlock was a member. We first consider the adequacy of the student-university relationship as a possible basis for imposing a duty on the University to control or prohibit the use of the trampoline, and then examine the provisions of the lease for that same purpose.

A.

The student-university relationship has been scrutinized in several jurisdictions, and it is generally agreed that a university is not an insurer of its students' safety. [Citations] The relationship between a university and its students has experienced important change over the years. At one time, college administrators and faculties stood in loco parentis to their students, which created a special relationship "that imposed a duty on the college to exercise control over student conduct and, reciprocally, gave the students certain rights of protection by the college." *Bradshaw,* 612 F.2d at 139. However, in modern times there has evolved a

gradual reapportionment of responsibilities from the universities to the students, and a corresponding departure from the in loco parentis relationship. *Id.* at 139–40. Today, colleges and universities are regarded as educational institutions rather than custodial ones. *Beach,* 726 P.2d at 419 (contrasting colleges and universities with elementary and high schools).

...

...By imposing a duty on the University in this case, the University would be encouraged to exercise more control over private student recreational choices, thereby effectively taking away much of the responsibility recently recognized in students for making their own decisions with respect to private entertainment and personal safety. Such an allocation of responsibility would "produce a repressive and inhospitable environment, largely inconsistent with the objectives of a modern college education." *Beach,* 726 P.2d at 419.

The evidence demonstrates that only in limited instances has the University attempted to impose regulations or restraints on the private recreational pursuits of its students, and the students have not looked to the University to assure the safety of their recreational choices. Nothing in the University's student handbook, which contains certain regulations concerning student conduct, reflects an effort by the University to control the risk-taking decisions of its students in their private recreation....Indeed, fraternity and sorority self-governance with minimal supervision appears to have been fostered by the University.

...

Aside from advising the Beta house on one occasion to put the trampoline up when not in use, there is no evidence that the University officials attempted to assert control over trampoline use by the fraternity members. We conclude from this record that the University's very limited actions concerning safety of student recreation did not give Whitlock or the other members of campus fraternities or sororities any reason to depend upon the University for evaluation of the safety of trampoline use....Therefore, we conclude that the student-university relationship is not a special relationship of the type giving rise to a duty of the University to take reasonable measures to protect the members of fraternities and sororities from risks of engaging in extra-curricular trampoline jumping.

The plaintiff asserts, however, that we should recognize a duty of the University to take affirmative action to protect fraternity members because of the foreseeability of the injury, the extent of the risks involved in trampoline use, the seriousness of potential injuries, and the University's superior knowledge concerning these matters. The argument in essence is that a duty should spring from the University's natural interest in the welfare and safety of its students, its superior knowledge of the nature and degree of risk involved in trampoline use, and its knowledge of the use of trampolines on the University campus. The evidence amply supports a conclusion that trampoline use involves risks of serious injuries and that the potential for an injury such as that experienced by Whitlock was foreseeable. It shows further that prior injuries resulting from trampoline accidents had been reported to campus security and to the student clinic, and that University administrators were aware of the number and severity of trampoline injuries nationwide.

The record, however, also establishes through Whitlock's own testimony that he was aware of the risk of an accident and injury of the very nature that he experienced....

We conclude that the relationship between the University and Whitlock was not one of dependence with respect to the activities at issue here, and provides no basis for the recognition of a duty of the University to take measures for protection of Whitlock against the injury that he suffered.

B.

We next examine the lease between the University and the fraternity to determine whether a special relationship between the University and Whitlock can be predicated on that document. The lease was executed in 1929, extends for a ninety-nine year term, and gives the fraternity the option to extend the term for another ninety-nine years. The premises are to be occupied and used by the fraternity "as a fraternity house, clubhouse, dormitory and boarding house, and generally for religious, educational, social and fraternal purposes." Such occupation is to be "*under control of the tenant.*" (emphasis added) The annual rental at all times relevant to this case appears from the record to be one dollar. The University has the obligation to maintain the grounds and make necessary repairs to the building, and the fraternity is to bear the cost of such maintenance and repair.

...

We conclude that the lease, and the University's actions pursuant to its rights under the lease, provide no basis of dependence by

the fraternity members upon which a special relationship can be found to exist between the University and the fraternity members that would give rise to a duty upon the University to take affirmative action to assure that recreational equipment such as a trampoline is not used under unsafe conditions.

IV.

Considering all of the factors presented, we are persuaded that under the facts of this case the University of Denver had no duty to Whitlock to eliminate the private use of trampolines on its campus or to supervise that use. There exists no special relationship between the parties that justifies placing a duty upon the University to protect Whitlock from the well-known dangers of using a trampoline. Here, a conclusion that a special relationship existed between Whitlock and the University sufficient to warrant the imposition of liability for nonfeasance would directly contravene the competing social policy of fostering an educational environment of student autonomy and independence.

We reverse the judgment of the court of appeals and return this case to that court with directions to remand it to the trial court for dismissal of Whitlock's complaint against the University.

CASE QUESTIONS

1. How are comparative negligence numbers calculated by the trial court? How can the jury say that the university is 72 percent negligent and that Whitlock is 28 percent negligent?
2. Why is this not an assumption of risk case?
3. Is there any evidence that Whitlock was contributorily negligent? If not, why would the court engage in comparative negligence calculations?

Negligence: Proximate Cause

Palsgraf v. Long Island R.R.

248 N.Y. 339,162 N.E. 99 (N.Y. 1928)

CARDOZO, Chief Judge

Plaintiff was standing on a platform of defendant's railroad after buying a ticket to go to Rockaway Beach. A train stopped at the station, bound for another place. Two men ran forward to catch it. One of the men reached the platform of the car without mishap, though the train was already moving. The other man, carrying a package, jumped aboard the car, but seemed unsteady as if about to fall. A guard on the car, who had held the door open, reached forward to help him in, and another guard on the platform pushed him from behind. In this act, the package was dislodged, and fell upon the rails. It was a package of small size, about fifteen inches long, and was covered by a newspaper. In fact it contained fireworks, but there was nothing in its appearance to give notice of its contents. The fireworks when they fell exploded. The shock of· the explosion threw down some scales at the other end of the platform many feet away. The scales struck the plaintiff, causing injuries for which she sues.

The conduct of the defendant's guard, if a wrong in its relation to the holder of the package, was not a wrong in its relation to the plaintiff, standing far away. Relatively to her it was not negligence at all. Nothing in the situation gave notice that the falling package had in it the potency of peril to persons thus removed. Negligence is not actionable unless it involves the invasion of a legally protected interest, the violation of a right. "Proof of negligence in the air, so to speak, will not do....If no hazard was apparent to the eye of ordinary vigilance, an act innocent and harmless, at least to outward seeming, with reference to her, did not take to itself the quality of a tort because it happened to be a wrong, though apparently not one involving the risk of bodily insecurity, with reference to someone else....The plaintiff sues in her own right for a wrong personal to her, and not as the vicarious beneficiary of a breach of duty to another.

A different conclusion will involve us, and swiftly too, in a maze of contradictions. A guard stumbles over a package which has been left upon a platform.

It seems to be a bundle of newspapers. It turns out to be a can of dynamite. To the eye of ordinary vigilance, the bundle is abandoned waste, which may be kicked or trod on with impunity. Is a passenger at the other end of the platform protected by the law against the unsuspected hazard concealed beneath the waste? If not, is the result to be any different, so far as the distant passenger is concerned, when the guard stumbles over a valise which a truckman or a porter has left upon the walk?...The orbit

of the danger as disclosed to the eye of reasonable vigilance would be the orbit of the duty. One who jostles one's neighbor in a crowd does not invade the rights of others standing at the outer fringe when the unintended contact casts a bomb upon the ground. The wrongdoer as to them is the man who carries the bomb, not the one who explodes it without suspicion of the danger. Life will have to be made over, and human nature transformed, before prevision so extravagant can be accepted as the norm of conduct, the customary standard to which behavior must conform.

The argument for the plaintiff is built upon the shifting meanings of such words as "wrong" and "wrongful" and shares their instability. For what the plaintiff must show is a "wrong" to herself; i.e., a violation of her own right, and not merely a "wrong" to someone else, nor conduct "wrongful" because unsocial, but not a "wrong" to anyone. We are told that one who drives at reckless speed through a crowded city street is guilty of a negligent act and therefore of a wrongful one, irrespective of the consequences.

Negligent the act is, and wrongful in the sense that it is unsocial, but wrongful and unsocial in relation to other travelers, only because the eye of vigilance perceives the risk of damage. If the same act were to be committed on a speedway or a race course, it would lose its wrongful quality. The risk reasonably to be perceived defines the duty to be obeyed, and risk imports relation; it is risk to another or to others within the range of apprehension. This does not mean, of course, that one who launches a destructive force is always relieved of liability, if the force, though known to be destructive, pursues an unexpected path....Some acts, such as shooting are so imminently dangerous to anyone who may come within reach of the missile however unexpectedly, as to impose a duty of prevision not far from that of an insurer. Even today, and much oftener in earlier stages of the law, one acts sometimes at one's peril....These cases aside, wrong-is defined in terms of the natural or probable, at least when unintentional....Negligence, like risk, is thus a term of relation.

Negligence in the abstract, apart from things related, is surely not a tort, if indeed it is understandable at all....One who seeks redress at law does not make out a cause of action by showing without more that there has been damage to his person. If the harm was not willful, he must show that the act as to him had possibilities of danger so many and apparent as to entitle him to be protected against the doing of it though the harm was unintended.

* * *

The judgment of the Appellate Division and that of the Trial Term should be reversed, and the complaint dismissed, with costs in all courts.

CASE QUESTIONS

1. Is there actual cause in this case? How can you tell?
2. Why should Mrs. Palsgraf (or her insurance company) be made to pay for injuries that were caused by the negligence of the Long Island Rail Road?
3. How is this accident *not* foreseeable?

Klein v. Pyrodyne Corporation

Klein v. Pyrodyne Corporation

810 P.2d 917 (Supreme Court of Washington 1991)

Pyrodyne Corporation (Pyrodyne) is a licensed fireworks display company that contracted to display fireworks at the Western Washington State Fairgrounds in Puyallup, Washington, on July 4,1987. During the fireworks display, one of the mortar launchers discharged a rocket on a horizontal trajectory parallel to the earth. The rocket exploded near a crowd of onlookers, including Danny Klein. Klein's clothing was set on fire, and he suffered facial burns and serious injury to his eyes. Klein sued Pyrodyne for strict liability to recover for his injuries. Pyrodyne asserted that the Chinese manufacturer of the fireworks was negligent in producing the rocket and therefore Pyrodyne should not be held liable. The trial court applied the doctrine of strict liability and held in favor of Klein. Pyrodyne appealed.

Section 519 of the Restatement (Second) of Torts provides that any party carrying on an "abnormally dangerous activity" is strictly liable for ensuing damages. The public display of fireworks fits this definition. The court stated: "Any time a person ignites rockets with the intention of sending them aloft to explode in the presence of large crowds of people, a high risk of serious personal injury or property damage is created. That risk arises because of the possibility that a rocket will malfunction or be misdirected." Pyrodyne argued that its liability was cut off by the Chinese manufacturer's negligence. The court rejected this argument, stating, "Even if negligence may properly be regarded as an intervening cause, it cannot function to relieve Pyrodyne from strict liability."

The Washington Supreme Court held that the public display of fireworks is an abnormally dangerous activity that warrants the imposition of strict liability.

Affirmed.

CASE QUESTIONS

1. Why would certain activities be deemed ultrahazardous or abnormally dangerous so that strict liability is imposed?
2. If the activities are known to be abnormally dangerous, did Klein assume the risk?
3. Assume that the fireworks were negligently manufactured in China. Should Klein's only remedy be against the Chinese company, as Pyrodyne argues? Why or why not?

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6.6: Summary and Exercises

Summary

The principles of tort law pervade modern society because they spell out the duties of care that we owe each other in our private lives. Tort law has had a significant impact on business because modern technology poses significant dangers and the modern market is so efficient at distributing goods to a wide class of consumers.

Unlike criminal law, tort law does not require the tortfeasor to have a specific intent to commit the act for which he or she will be held liable to pay damages. Negligence—that is, carelessness—is a major factor in tort liability. In some instances, especially in cases involving injuries caused by products, a no-fault standard called strict liability is applied.

What constitutes a legal injury depends very much on the circumstances. A person can assume a risk or consent to the particular action, thus relieving the person doing the injury from tort liability. To be liable, the tortfeasor must be the proximate cause of the injury, not a remote cause. On the other hand, certain people are held to answer for the torts of another—for example, an employer is usually liable for the torts of his employees, and a bartender might be liable for injuries caused by someone to whom he sold too many drinks. Two types of statutes—workers' compensation and no-fault automobile insurance—have eliminated tort liability for certain kinds of accidents and replaced it with an immediate insurance payment plan.

Among the torts of particular importance to the business community are wrongful death and personal injury caused by products or acts of employees, misrepresentation, defamation, and interference with contractual relations.

EXERCISES

1. What is the difference in objectives between tort law and criminal law?
2. A woman fell ill in a store. An employee put the woman in an infirmary but provided no medical care for six hours, and she died. The woman's family sued the store for wrongful death. What arguments could the store make that it was not liable? What arguments could the family make? Which seem the stronger arguments? Why?
3. The signals on a railroad crossing are defective. Although the railroad company was notified of the problem a month earlier, the railroad inspector has failed to come by and repair them. Seeing the all-clear signal, a car drives up and stalls on the tracks as a train rounds the bend. For the past two weeks the car had been stalling, and the driver kept putting off taking the car to the shop for a tune-up. As the train rounds the bend, the engineer is distracted by a conductor and does not see the car until it is too late to stop. Who is negligent? Who must bear the liability for the damage to the car and to the train?
4. Suppose in the *Katko v. Briney* case (Section 7.2 "Intentional Torts") that instead of setting such a device, the defendants had simply let the floor immediately inside the front door rot until it was so weak that anybody who came in and took two steps straight ahead would fall through the floor and to the cellar. Will the defendant be liable in this case? What if they invited a realtor to appraise the place and did not warn her of the floor? Does it matter whether the injured person is a trespasser or an invitee?
5. Plaintiff's husband died in an accident, leaving her with several children and no money except a valid insurance policy by which she was entitled to $5,000. Insurance Company refused to pay, delaying and refusing payment and meanwhile "inviting" Plaintiff to accept less than $5,000, hinting that it had a defense. Plaintiff was reduced to accepting housing and charity from relatives. She sued the insurance company for bad-faith refusal to settle the claim and for the intentional infliction of emotional distress. The lower court dismissed the case. Should the court of appeals allow the matter to proceed to trial?

SELF-TEST QUESTIONS

1. Catarina falsely accuses Jeff of stealing from their employer. The statement is defamatory only if
    1. a third party hears it
    2. Nick suffers severe emotional distress as a result
    3. the statement is the actual and proximate cause of his distress
    4. the statement is widely circulated in the local media and on Twitter
2. Garrett files a suit against Colossal Media Corporation for defamation. Colossal has said that Garrett is a "sleazy, corrupt

public official" (and provided some evidence to back the claim). To win his case, Garrett will have to show that Colossal acted with
   1. malice
   2. ill will
   3. malice aforethought
   4. actual malice
3. Big Burger begins a rumor, using social media, that the meat in Burger World is partly composed of ground-up worms. The rumor is not true, as Big Burger well knows. Its intent is to get some customers to shift loyalty from Burger World to Big Burger. Burger World's best cause of action would be
   1. trespass on the case
   2. nuisance
   3. product disparagement
   4. intentional infliction of emotional distress
4. Wilfred Phelps, age 65, is driving his Nissan Altima down Main Street when he suffers the first seizure of his life. He loses control of his vehicle and runs into three people on the sidewalk. Which statement is true?
   1. He is liable for an intentional tort.
   2. He is liable for a negligent tort.
   3. He is not liable for a negligent tort.
   4. He is liable under strict liability, because driving a car is abnormally dangerous.
5. Jonathan carelessly bumps into Amanda, knocking her to the ground. He has committed the tort of negligence
   1. only if Amanda is injured
   2. only if Amanda is not injured
   3. whether or not Amanda is injured

SELF-TEST AnswerS

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

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7: INTRODUCTION TO CONTRACT LAW

Learning Objectives

After reading this chapter, you should understand the following:

1. Why and how contract law has developed
2. What a contract is
3. What topics will be discussed in the contracts chapter of this book
4. What the sources of contract law are
5. How contracts are classified (basic taxonomy)

7.1: Case Law and the Uniform Commercial Code

7.2: Sources of Contract Law

7.3: Nature and Terminology of Contracts

7.4: Cases

7.5: Summary and Exercises

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7.1: Case Law and the Uniform Commercial Code

LEARNING OBJECTIVES

1. Explain contract law's cultural roots: how it evolved alongside capitalism.
2. Understand that contracts serve essential economic purposes.
3. Define what a contract is.
4. Recognize the basic issues in contract law.

The Role of Contracts in Modern Society

Imagine a small business owner, Elena, who wants to open a café. She signs a lease with a landlord, a purchase order with a supplier, and an employment agreement with her first barista. Without contracts, her entire business plan would be unstable—she would have no legal assurance that her landlord won't evict her without cause, her supplier won't suddenly stop delivering, or her barista won't leave after one day.

This illustrates why contract law is central to modern society. In everyday language we call it an "agreement," a "deal," or even just a "promise." But legally, contracts provide a framework of trust and accountability in a world where strangers, businesses, and governments must cooperate.

Historically, this was not always the case. In feudal Europe, people's rights and duties were determined mostly by status—family, tribe, or landholding—not by free choice. A person was born into obligations. As British historian Sir Henry Maine observed in 1869, the great shift of modern societies has been "from status to contract." With the rise of trade, cities, and industry from the fifteenth to nineteenth centuries, people increasingly relied on voluntary agreements, and contract law grew as capitalism grew.

By the nineteenth century, both English and American courts had built a full body of contract law, often reluctantly, since judges sometimes preferred the "simpler" world of their forefathers. But modern capitalism would not exist without enforceable contracts. Planned economies such as the former Soviet Union or pre-1999 China gave contracts a secondary role, with the state dictating terms. Today, even those systems have adopted modern contract codes to enable global commerce.

The Economic Purposes of Contracts

Contract law is not only cultural—it also serves important economic functions. Judge Richard Posner famously described three:

1. **Encouraging exchange** – By enforcing agreements, the law ensures people trust that bargains will be honored.
2. **Reducing transaction costs** – Established rules mean parties don't have to renegotiate every detail each time.
3. **Alerting parties to risks** – Legal precedents highlight past disputes, helping businesses plan around pitfalls.

Elena's café lease, for example, doesn't need to spell out every possible scenario because contract law already provides background rules on remedies, duties, and performance.

What Is a Contract?

Formally, the Restatement (Second) of Contracts defines a contract as "a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty." The Uniform Commercial Code (UCC) similarly describes it as "the total legal obligation" created by an agreement and applicable law.

In simpler terms: **a contract is a legally enforceable promise.** Not every promise qualifies. If Elena bets her friend $100 on a baseball game, even with a handshake, most courts would not enforce it. The law considers how the agreement was made, who made it, and for what purpose.

Overview of This Chapter

Contract law has many details, but it largely revolves around four core questions:

1. **Did the parties create a valid contract?**
   - Requires mutual assent (offer and acceptance), consideration, real assent (no fraud, duress, or incapacity), and legality.
2. **What does the contract mean, and is it in the proper form?**
   - Some contracts must be in writing, and courts often must interpret ambiguous terms.
3. **Do outsiders have rights or duties?**
   - Can rights be assigned or duties delegated? Can a third party enforce the contract?
4. **How do duties end, and what happens if someone breaches?**
   - Termination, discharge, and remedies.

KEY TAKEAWAY

Contract law grew out of the decline of rigid feudal obligations and the rise of capitalism, where people freely choose relationships through mutual agreement. Contracts serve vital cultural and economic functions: they protect freedom of choice, reduce risk, and enable commerce. A contract is not just a promise—it is a promise the law will enforce.

EXERCISES

1. Why is contract law necessary in a society where a person's status is not predetermined by birth?
2. Contract law serves some economic functions. What are they?

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7.2: Sources of Contract Law

LEARNING OBJECTIVES

1. Understand that contract law comes from two sources: judges (cases) and legislation.
2. Know what the Restatement of Contracts is.
3. Recognize the Convention on Contracts for the International Sale of Goods.

The most important sources of contract law are state case law and state statutes (though there are also many federal statutes governing how contracts are made by and with the federal government).

Case Law

Law made by judges is called **case law**. Because contract law was made up in the common-law courtroom by individual judges as they applied rules to resolve disputes before them, it grew over time to formidable proportions. By the early twentieth century, tens of thousands of contract disputes had been submitted to the courts for resolution, and the published opinions, if collected in one place, would have filled dozens of bookshelves. Clearly this mass of material was too unwieldy for efficient use. A similar problem also had developed in the other leading branches of the common law.

Disturbed by the profusion of cases and the resulting uncertainty of the law, a group of prominent American judges, lawyers, and law teachers founded the American Law Institute (ALI) in 1923 to attempt to clarify, simplify, and improve the law. One of the ALI's first projects, and ultimately one of its most successful, was the drafting of the **Restatement of the Law of Contracts**, completed in 1932. A revision—the Restatement (Second) of Contracts—was undertaken in 1964 and completed in 1979. Hereafter, references to "the Restatement" pertain to the Restatement (Second) of Contracts.

The Restatements—others exist in the fields of torts, agency, conflicts of laws, judgments, property, restitution, security, and trusts—are detailed analyses of the decided cases in each field. These analyses are made with an eye to discerning the various principles that have emerged from the courts, and to the maximum extent possible, the Restatements declare the law as the courts have determined it to be. The Restatements, guided by a reporter (the director of the project) and a staff of legal scholars, go through several so-called tentative drafts—sometimes as many as fifteen or twenty—and are screened by various committees within the ALI before they are eventually published as final documents.

The Restatement (Second) of Contracts won prompt respect in the courts and has been cited in innumerable cases. The Restatements are not authoritative, in the sense that they are not actual judicial precedents; but they are nevertheless weighty interpretive texts, and judges frequently look to them for guidance. They are as close to "black letter" rules of law as exist anywhere in the American common-law legal system.

Common law, case law (the terms are synonymous), governs contracts for the sale of real estate and services. "Services" refer to acts or deeds (like plumbing, drafting documents, driving a car) as opposed to the sale of property.

Statutory Law: The Uniform Commercial Code

Common-law contract principles govern contracts for real estate and services. Because of the historical development of the English legal system, contracts for the sale of goods came to be governed by a different body of legal rules. In its modern American manifestation, that body of rules is an important statute: the **Uniform Commercial Code (UCC)**, especially **Article 2**, which deals with the sale of goods.

History of the UCC

A bit of history is in order. Before the UCC was written, commercial law varied, sometimes greatly, from state to state. This first proved a nuisance and then a serious impediment to business as the American economy became nationwide during the twentieth century. Although there had been some uniform laws concerned with commercial deals—including the Uniform Sales Act, first published in 1906—few were widely adopted and none nationally. As a result, the law governing sales of goods, negotiable

instruments, warehouse receipts, securities, and other matters crucial to doing business in an industrial market economy was a crazy quilt of untidy provisions that did not mesh well from state to state.

The UCC is a model law developed by the ALI and the National Conference of Commissioners on Uniform State Laws; it has been adopted in one form or another by the legislatures in all fifty states, the District of Columbia, and the American territories. It is a "national" law not enacted by Congress—it is not federal law but uniform state law.

Initial drafting of the UCC began in 1942 and was ten years in the making, involving the efforts of hundreds of practicing lawyers, law teachers, and judges. A final draft, promulgated by the ALI, was endorsed by the American Bar Association and published in 1951. Various revisions followed in different states, threatening the uniformity of the UCC. The ALI responded by creating a permanent editorial board to oversee future revisions. In one or another of its various revisions, the UCC has been adopted in whole or in part in all American jurisdictions. The UCC is now a basic law of relevance to every business and business lawyer in the United States, even though it is not entirely uniform because different states have adopted it at various stages of its evolution—an evolution that continues still.

Organization of the UCC

The UCC consists of nine major substantive articles; each deals with separate though related subjects. The articles are as follows:

- Article 1: General Provisions
- Article 2: Sales
- Article 2A: Leases
- Article 3: Commercial Paper
- Article 4: Bank Deposits and Collections
- Article 4A: Funds Transfers
- Article 5: Letters of Credit
- Article 6: Bulk Transfers
- Article 7: Warehouse Receipts, Bills of Lading, and Other Documents of Title
- Article 8: Investment Securities
- Article 9: Secured Transactions

Article 2 deals only with the sale of goods, which the UCC defines as "all things...which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid."Uniform Commercial Code, Section 2-105. The only contracts and agreements covered by Article 2 are those relating to the present or future sale of goods.

Article 2 is divided in turn into six major parts: (1) Form, Formation, and Readjustment of Contract; (2) General Obligation and Construction of Contract; (3) Title, Creditors, and Good Faith Purchasers; (4) Performance; (5) Breach, Repudiation, and Excuse; and (6) Remedies. These topics will be discussed in Chapter 17 "Introduction to Sales and Leases", Chapter 18 "Title and Risk of Loss", Chapter 19 "Performance and Remedies", Chapter 20 "Products Liability", and Chapter 21 "Bailments and the Storage, Shipment, and Leasing of Goods".

Figure 8.1 Sources of Law

Type of Contract	Source of Law: Common Law	Source of Law: UCC
Real Estate	✓	
Services	✓	
Sale of Goods		✓

International Sales Law

The Convention on Contracts for the International Sale of Goods

A **Convention on Contracts for the International Sale of Goods (CISG)** was approved in 1980 at a diplomatic conference in Vienna. (A convention is a preliminary agreement that serves as the basis for a formal treaty.) The CISG has been adopted by more than forty countries, including the United States.

The CISG is significant for three reasons. First, it is a uniform law governing the sale of goods—in effect, an international Uniform Commercial Code. The major goal of the drafters was to produce a uniform law acceptable to countries with different legal, social, and economic systems. Second, although provisions in the CISG are generally consistent with the UCC, there are significant differences. For instance, under the CISG, consideration (discussed in Chapter 11 "Consideration") is not required to form a contract, and there is no Statute of Frauds (a requirement that certain contracts be evidenced by a writing). Third, the CISG represents the first attempt by the US Senate to reform the private law of business through its treaty powers, for the CISG preempts the UCC. The CISG is not mandatory: parties to an international contract for the sale of goods may choose to have their agreement governed by different law, perhaps the UCC, or perhaps, say, Japanese contract law. The CISG does not apply to contracts for the sale of (1) ships or aircraft, (2) electricity, or (3) goods bought for personal, family, or household use, nor does it apply (4) where the party furnishing the goods does so only incidentally to the labor or services part of the contract.

KEY TAKEAWAY

Judges have made contract law over several centuries by deciding cases that create, extend, or change the developing rules affecting contract formation, performance, and enforcement. The rules from the cases have been abstracted and organized in the Restatements of Contracts. To facilitate interstate commerce, contract law for many commercial transactions—especially the sale of goods—not traditionally within the purview of judges has been developed by legal scholars and presented for the states to adopt as the Uniform Commercial Code. There is an analogous Convention on Contracts for the International Sale of Goods, to which the United States is a party.

EXERCISES

1. How do judges make contract law?
2. What is the Restatement of the Law of Contracts, and why was it necessary?
3. Why was the Uniform Commercial Code developed, and by whom?
4. Who adopts the UCC as governing law?
5. What is the Convention on Contracts for the International Sale of Goods?

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7.3: Nature and Terminology of Contracts

LEARNING OBJECTIVES

1. Understand that contracts are classified according to the criteria of explicitness, mutuality, enforceability, and degree of completion and that some noncontract promises are nevertheless enforceable under the doctrine of promissory estoppel.
2. Keep your eyes (and ears) alert to the use of suffixes (word endings) in legal terminology that express relationships between parties.

Some contracts are written, some oral; some are explicit, some not. Because contracts can be formed, expressed, and enforced in a variety of ways, a taxonomy of contracts has developed that is useful in grouping together like legal consequences. In general, contracts are classified along four different dimensions: explicitness, mutuality, enforceability, and degree of completion. Explicitness is the degree to which the agreement is manifest to those not party to it. Mutuality takes into account whether promises are given by two parties or only one. Enforceability is the degree to which a given contract is binding. Completion considers whether the contract is yet to be performed or whether the obligations have been fully discharged by one or both parties. We will examine each of these concepts in turn.

Explicitness

Express Contract

An **express contract** is one in which the terms are spelled out directly. The parties to an express contract, whether it is written or oral, are conscious that they are making an enforceable agreement. For example, an agreement to purchase your neighbor's car for $5,500 and to take title next Monday is an express contract.

Implied Contract (Implied in Fact)

An **implied contract** is one that is inferred from the actions of the parties. When parties have not discussed terms, an implied contract exists if it is clear from the conduct of both parties that they intended there be one. A delicatessen patron who asks for a turkey sandwich to go has made a contract and is obligated to pay when the sandwich is made. By ordering the food, the patron is implicitly agreeing to the price, whether posted or not.

The distinction between express and implied contracts has received a degree of notoriety in the so-called palimony cases, in which one member of an unmarried couple seeks a division of property after a long-standing live-together relationship has broken up. When a married couple divorces, their legal marriage contract is dissolved, and financial rights and obligations are spelled out in a huge body of domestic relations statutes and judicial decisions. No such laws exist for unmarried couples. However, about one-third of the states recognize common-law marriage, under which two people are deemed to be married if they live together with the intent to be married, regardless of their failure to have obtained a license or gone through a ceremony. Although there is no actual contract of marriage (no license), their behavior implies that the parties intended to be treated as if they were married.

Quasi-Contract

A **quasi-contract (implied in law)** is—unlike both express and implied contracts, which embody an actual agreement of the parties—an obligation said to be "imposed by law" in order to avoid unjust enrichment of one person at the expense of another. A quasi-contract is not a contract at all; it is a fiction that the courts created to prevent injustice. Suppose, for example, that the local lumberyard mistakenly delivers a load of lumber to your house, where you are repairing your deck. It was a neighbor on the next block who ordered the lumber, but you are happy to accept the load for free; since you never talked to the lumberyard, you figure you need not pay the bill. Although it is true there is no contract, the law implies a contract for the value of the material: of course you will have to pay for what you got and took. The existence of this implied contract does not depend on the intention of the parties.

Mutuality

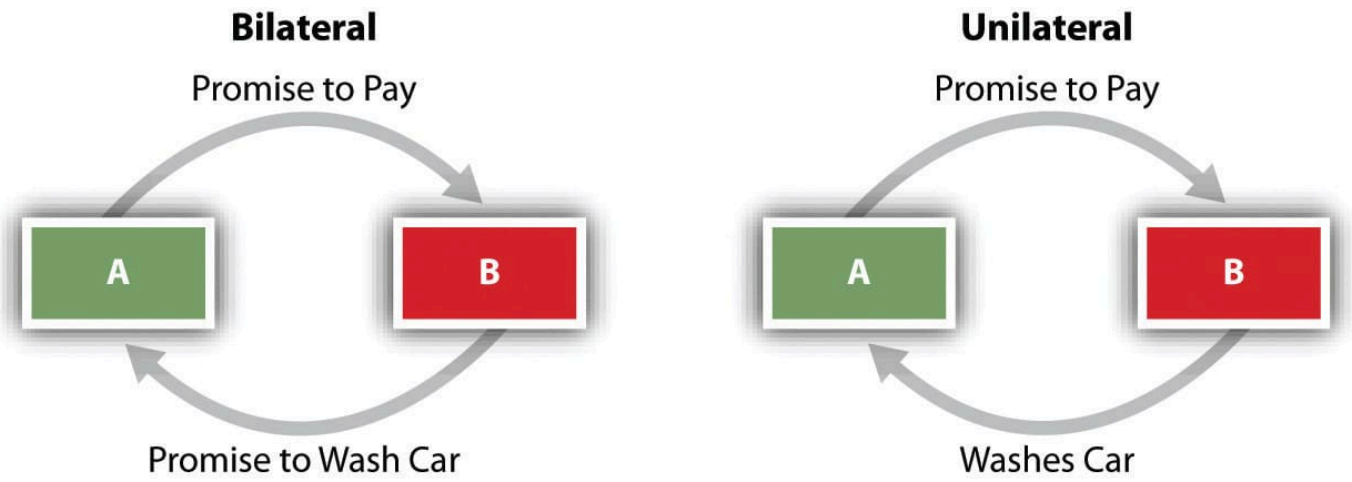
Bilateral Contract

The typical contract is one in which the parties make mutual promises. Each is both promisor and promisee; that is, each pledges to do something, and each is the recipient of such a pledge. This type of contract is called a **bilateral contract**.

Unilateral Contract

Mutual promises are not necessary to constitute a contract. **Unilateral contracts**, in which one party performs an act in exchange for the other party's promise, are equally valid. An offer of a reward—for catching a criminal or for returning a lost cat—is an example of a unilateral contract: there is an offer on one side, and the other side accepts by taking the action requested.

Figure 8.2 Bilateral and Unilateral Contracts



Enforceability

Void

Not every agreement between two people is a binding contract. An agreement that is lacking one of the legal elements of a contract is said to be a **void contract**—that is, not a contract at all. An agreement that is illegal—for example, a promise to commit a crime in return for a money payment—is void. Neither party to a void "contract" may enforce it.

Voidable

By contrast, a **voidable contract** is one that may become unenforceable by one party but can be enforced by the other. For example, a minor (any person under eighteen, in most states) may "avoid" a contract with an adult; the adult may not enforce the contract against the minor if the minor refuses to carry out the bargain. But the adult has no choice if the minor wishes the contract to be performed. (A contract may be voidable by both parties if both are minors.)

Ordinarily, the parties to a voidable contract are entitled to be restored to their original condition. Suppose you agree to buy your seventeen-year-old neighbor's car. He delivers it to you in exchange for your agreement to pay him next week. He has the legal right to terminate the deal and recover the car, in which case you will of course have no obligation to pay him. If you have already paid him, he still may legally demand a return to the status quo ante (previous state of affairs). You must return the car to him; he must return the cash to you.

A voidable contract remains a valid contract until it is voided. Thus a contract with a minor remains in force unless the minor

decides he or she does not wish to be bound by it. When the minor reaches majority, he or she may "ratify" the contract—that is, agree to be bound by it—in which case the contract will no longer be voidable and will thereafter be fully enforceable.

Common situations that give rise to voidable contracts include:

1. **Contracts with Minors** – Because minors generally lack legal capacity, contracts they enter into are voidable at the minor's option. The minor may affirm or disaffirm the agreement before or shortly after reaching the age of majority.
2. **Contracts Induced by Fraud or Misrepresentation** – If one party was tricked or misled into entering a contract, the deceived party may void the contract.
3. **Contracts Signed Under Duress or Undue Influence** – When consent is obtained through threats, coercion, or unfair persuasion, the victimized party may avoid the agreement.
4. **Contracts with Mentally Incompetent Persons** – Contracts entered into by someone lacking mental capacity (but not yet declared legally insane) may be voidable at that person's option.
5. **Certain Intoxicated Persons** – A contract made while one party was so intoxicated that they could not understand the nature and consequences of the transaction may be voidable once sobriety is regained.

In all these cases, the harmed or protected party has the **choice** to either enforce or rescind the contract.

Unenforceable

An **unenforceable contract** is one that some rule of law bars a court from enforcing. For example, Tom owes Pete money, but Pete has waited too long to collect it and the statute of limitations has run out. The contract for repayment is unenforceable and Pete is out of luck, unless Tom makes a new promise to pay or actually pays part of the debt. (However, if Pete is holding collateral as security for the debt, he is entitled to keep it; not all rights are extinguished because a contract is unenforceable.) A debt becomes unenforceable, too, when the debtor declares bankruptcy.

A bit more on enforceability is in order. A promise or what seems to be a promise is usually enforceable only if it is otherwise embedded in the elements necessary to make that promise a contract. Those elements are mutual assent, real assent, consideration, capacity, and legality. Sometimes, though, people say things that seem like promises, and on which another person relies. In the early twentieth century, courts began, in some circumstances, to recognize that insisting on the existence of the traditional elements of contract to determine whether a promise is enforceable could work an injustice where there has been reliance. Thus developed the equitable doctrine of **promissory estoppel**, which has become an important adjunct to contract law. The Restatement (Section 90) puts it this way: "A promise which the promisor should reasonably expect to induce action or forbearance on the party of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires."

To be "estopped" means to be prohibited from denying now the validity of a promise you made before.

The doctrine has an interesting background. In 1937, High Trees House Ltd. (a British corporation) leased a block of London apartments from Central London Properties. As World War II approached, vacancy rates soared because people left the city. In 1940 the parties agreed to reduce the rent rates by half, but no term was set for how long the reduction would last. By mid-1945, as the war was ending, occupancy was again full, and Central London sued for the full rental rates from June on. The English court, under Judge Alfred Thompson Denning (1899–1999), had no difficulty finding that High Trees owed the full amount once full occupancy was again achieved, but Judge Denning went on. In an aside (called a dicta—a statement "by the way"—that is, not necessary as part of the decision), he mused about what would have happened if in 1945 Central London had sued for the full-occupancy rate back to 1940. Technically, the 1940 amendment to the 1937 contract was not binding on Central London—it lacked consideration—and Central London could have reached back to demand full-rate payment. But Judge Denning said that High Trees would certainly have relied on Central London's promise that a reduced-rate rent would be acceptable, and that would have been enough to bind it, to prevent it from acting inconsistently with the promise. He wrote, "The courts have not gone so far as to give a cause of action in damages for the breach of such a promise, but they have refused to allow the party making it to act inconsistently with it."*Central London Property Trust Ltd. v. High Trees House Ltd.* (1947) KB 130.

In the years since, though, courts *have* gone so far as to give a cause of action in damages for various noncontract promises. Contract protects agreements; promissory estoppel protects reliance, and that's a significant difference. The law of contracts continues to evolve.

Degree of Completion

An agreement consisting of a set of promises is called an **executory contract** before any promises are carried out. Most executory contracts are enforceable. If John makes an agreement to deliver wheat to Humphrey and does so, the contract is called a **partially executed contract**: one side has performed, the other has not. When John pays for the wheat, the contract is fully performed. A contract that has been carried out fully by both parties is called an **executed contract**.

Terminology: Suffixes Expressing Relationships

Although not really part of the taxonomy of contracts (i.e., the orderly classification of the subject), an aspect of contractual—indeed, legal—terminology should be highlighted here. *Suffixes* (the end syllables of words) in the English language are used to express relationships between parties in legal terminology. Here are examples:

- **Offeror.** One who makes an offer.
- **Offeree.** One to whom an offer is made.
- **Promisor.** One who makes a promise.
- **Promisee.** One to whom a promise is made.
- **Obligor.** One who makes and has an obligation.
- **Obligee.** One to whom an obligation is made.
- **Transferor.** One who makes a transfer.
- **Transferee.** One to whom a transfer is made.

KEY TAKEAWAY

Contracts are described and thus defined on the basis of four criteria: explicitness (express, implied, or quasi-contracts), mutuality (bilateral or unilateral), enforceability (void, voidable, unenforceable), and degree of completion (executory, partially executed, executed). Legal terminology in English often describes relationships between parties by the use of suffixes, to which the eye and ear must pay attention.

EXERCISES

1. Able *write*s to Baker: "I will mow your lawn for $20." If Baker accepts, is this an express or implied contract?
2. Able *telephone*s Baker: "I will mow your lawn for $20." Is this an express or implied contract?
3. What is the difference between a void contract and a voidable one?
4. Carr staples this poster to a utility pole: "$50 reward for the return of my dog, Argon." Describe this in contractual terms regarding explicitness, mutuality, enforceability, and degree of completion.
5. Is a voidable contract always unenforceable?
6. Contractor bids on a highway construction job, incorporating Guardrail Company's bid into its overall bid to the state. Contractor cannot accept Guardrail's offer until it gets the nod from the state. Contractor gets the nod from the state, but before it can accept Guardrail's offer, the latter revokes it. Usually a person can revoke an offer any time before it is accepted. Can Guardrail revoke its offer in this case?

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7.4: Cases

Explicitness: Implied Contract

Roger's Backhoe Service, Inc. v. Nichols

681 N.W.2d 647 (Iowa 2004)

Carter, J.

Defendant, Jeffrey S. Nichols, is a funeral director in Muscatine....In early 1998 Nichols decided to build a crematorium on the tract of land on which his funeral home was located. In working with the Small Business Administration, he was required to provide drawings and specifications and obtain estimates for the project. Nichols hired an architect who prepared plans and submitted them to the City of Muscatine for approval. These plans provided that the surface water from the parking lot would drain onto the adjacent street and alley and ultimately enter city storm sewers. These plans were approved by the city.

Nichols contracted with Roger's [Backhoe Service, Inc.] for the demolition of the foundation of a building that had been razed to provide room for the crematorium and removal of the concrete driveway and sidewalk adjacent to that foundation. Roger's completed that work and was paid in full.

After construction began, city officials came to the jobsite and informed Roger's that the proposed drainage of surface water onto the street and alley was unsatisfactory. The city required that an effort be made to drain the surface water into a subterranean creek, which served as part of the city's storm sewer system. City officials indicated that this subterranean sewer system was about fourteen feet below the surface of the ground....Roger's conveyed the city's mandate to Nichols when he visited the jobsite that same day.

It was Nichols' testimony at trial that, upon receiving this information, he advised...Roger's that he was refusing permission to engage in the exploratory excavation that the city required. Nevertheless, it appears without dispute that for the next three days Roger's did engage in digging down to the subterranean sewer system, which was located approximately twenty feet below the surface. When the underground creek was located, city officials examined the brick walls in which it was encased and determined that it was not feasible to penetrate those walls in order to connect the surface water drainage with the underground creek. As a result of that conclusion, the city reversed its position and once again gave permission to drain the surface water onto the adjacent street and alley.

[T]he invoices at issue in this litigation relate to charges that Roger's submitted to Nichols for the three days of excavation necessary to locate the underground sewer system and the cost for labor and materials necessary to refill the excavation with compactable materials and attain compaction by means of a tamping process....The district court found that the charges submitted on the...invoices were fair and reasonable and that they had been performed for Nichols' benefit and with his tacit approval....

The court of appeals...concluded that a necessary element in establishing an implied-in-fact contract is that the services performed be beneficial to the alleged obligor. It concluded that Roger's had failed to show that its services benefited Nichols....

In describing the elements of an action on an implied contract, the court of appeals stated in [Citation], that the party seeking recovery must show:

(1) the services were carried out under such circumstances as to give the recipient reason to understand:

(a) they were performed for him and not some other person, and

(b) they were not rendered gratuitously, but with the expectation of compensation from the recipient; and

(2) *the services were beneficial to the recipient.*

In applying the italicized language in [Citation] to the present controversy, it was the conclusion of the court of appeals that Roger's' services conferred no benefit on Nichols. We disagree. There was substantial evidence in the record to support a finding

that, unless and until an effort was made to locate the subterranean sewer system, the city refused to allow the project to proceed. Consequently, it was necessary to the successful completion of the project that the effort be made. The fact that examination of the brick wall surrounding the underground creek indicated that it was unfeasible to use that source of drainage does not alter the fact that the project was stalemated until drainage into the underground creek was fully explored and rejected. The district court properly concluded that Roger's' services conferred a benefit on Nichols....

Decision of court of appeals vacated; district court judgment affirmed.

CASE QUESTIONS

1. What facts must be established by a plaintiff to show the existence of an implied contract?
2. What argument did Nichols make as to why there was no implied contract here?
3. How would the facts have to be changed to make an express contract?

Mutuality of Contract: Unilateral Contract

SouthTrust Bank v. Williams

775 So.2d 184 (Ala. 2000)

Cook, J.

SouthTrust Bank ("SouthTrust") appeals from an order denying its motion to compel arbitration of an action against it by checking-account customers Mark Williams and Bessie Daniels. We reverse and remand.

Daniels and Williams began their relationship with SouthTrust in 1981 and 1995, respectively, by executing checking-account "signature cards." The signature card each customer signed contained a "change-in-terms" clause. Specifically, when Daniels signed her signature card, she "agree[d] to be subject to the Rules and Regulations as may now or *hereafter* be adopted by the Bank." (Emphasis added.)...[Later,] SouthTrust added paragraph 33 to the regulations:...

ARBITRATION OF DISPUTES. You and we agree that the transactions in your account involve 'commerce' under the Federal Arbitration Act ('FAA'). ANY CONTROVERSY OR CLAIM BETWEEN YOU AND US...WILL BE SETTLED BY BINDING ARBITRATION UNDER THE FAA....

This action...challenges SouthTrust's procedures for paying overdrafts, and alleges that SouthTrust engages in a "uniform practice of paying the largest check(s) before paying multiple smaller checks...[in order] to generate increased service charges for [SouthTrust] at the expense of [its customers]."

SouthTrust filed a "motion to stay [the] lawsuit and to compel arbitration." It based its motion on paragraph 33 of the regulations. [T]he trial court...entered an order denying SouthTrust's motion to compel arbitration. SouthTrust appeals....

Williams and Daniels contend that SouthTrust's amendment to the regulations, adding paragraph 33, was ineffective because, they say, they did not *expressly assent* to the amendment. In other words, they object to submitting their claims to arbitration because, they say, when they opened their accounts, neither the regulations nor any other relevant document contained an arbitration provision. They argue that "mere failure to object to the addition of a material term cannot be construed as an acceptance of it."...They contend that SouthTrust could not unilaterally insert an arbitration clause in the regulations and make it binding on depositors like them.

SouthTrust, however, referring to its change-of-terms clause insists that it "notified" Daniels and Williams of the amendment in January 1997 by enclosing in each customer's "account statement" a complete copy of the regulations, as amended. Although it is undisputed that Daniels and Williams never affirmatively assented to these amended regulations, SouthTrust contends that their assent was evidenced by their failure to close their accounts after they received notice of the amendments....Thus, the disposition of this case turns on the legal effect of Williams and Daniels's continued use of the accounts after the regulations were amended.

Williams and Daniels argue that "[i]n the context of contracts between merchants [under the UCC], a written confirmation of an acceptance may modify the contract *unless* it adds a *material* term, and arbitration clauses are material terms."...

Williams and Daniels concede—as they must—...that Article 2 governs "transactions in goods," and, consequently, that it is not

applicable to the transactions in this case. Nevertheless, they argue:

It would be astonishing if a Court were to consider the addition of an arbitration clause a material alteration to a contract between merchants, who by definition are sophisticated in the trade to which the contract applies, but *not* hold that the addition of an arbitration clause is a material alteration pursuant to a change-of-terms clause in a contract between one sophisticated party, a bank, and an entire class of less sophisticated parties, its depositors....

In response, SouthTrust states that "because of the 'at-will' nature of the relationship, banks by necessity must contractually reserve the right to amend their deposit agreements from time to time." In so stating, SouthTrust has precisely identified the fundamental difference between the transactions here and those transactions governed by [Article 2].

Contracts for the purchase and sale of goods are essentially *bilateral* and executory in nature. See [Citation] "An agreement whereby one party promises to sell and the other promises to buy a thing at a later time...is a bilateral promise of sale or contract to sell"...."[A] unilateral contract results from an exchange of a promise for an act; a bilateral contract results from an exchange of promises."...Thus, "in a unilateral contract, there is no bargaining process or exchange of promises by parties as in a bilateral contract." [Citation] "[O]nly one party makes an offer (or promise) which invites performance by another, and performance constitutes both acceptance of that offer and consideration." Because "a 'unilateral contract' is one in which no promisor receives promise as consideration for his promise," only one party is bound....The difference is not one of semantics but of substance; it determines the rights and responsibilities of the parties, including the time and the conditions under which a cause of action accrues for a breach of the contract.

This case involves at-will, commercial relationships, based upon a series of unilateral transactions. Thus, it is more analogous to cases involving insurance policies, such as [Citations]. The common thread running through those cases was the *amendment* by one of the parties to a business relationship of a document underlying that relationship—without the express assent of the other party—to require the arbitration of disputes arising after the amendment....

The parties in [the cited cases], like Williams and Daniels in this case, took no action that could be considered inconsistent with an assent to the arbitration provision. In each case, they continued the business relationship after the interposition of the arbitration provision. In doing so, they implicitly assented to the addition of the arbitration provision....

Reversed and remanded.

CASE QUESTIONS

1. Why did the plaintiffs think they should not be bound by the arbitration clause?
2. The court said this case involved a unilateral contract. What makes it that, as opposed to a bilateral contract?
3. What should the plaintiffs have done if they didn't like the arbitration requirement?

Unilateral Contract and At-Will Employment

Woolley v. Hoffmann-La Roche, Inc.

491 A.2d 1257 (N.J. 1985)

Wilntz, C. J.

Plaintiff, Richard Woolley, was hired by defendant, Hoffmann-La Roche, Inc., in October 1969, as an Engineering Section Head in defendant's Central Engineering Department at Nutley. There was no written employment contract between plaintiff and defendant. Plaintiff began work in mid-November 1969. Sometime in December, plaintiff received and read the personnel manual on which his claims are based.

[The company's personnel manual had eight pages;] five of the eight pages are devoted to "termination." In addition to setting forth the purpose and policy of the termination section, it defines "the types of termination" as "layoff," "discharge due to performance," "discharge, disciplinary," "retirement" and "resignation." As one might expect, layoff is a termination caused by lack of work, retirement a termination caused by age, resignation a termination on the initiative of the employee, and discharge due to performance and discharge, disciplinary, are both terminations for cause. There is no category set forth for discharge without cause. The termination section includes "Guidelines for discharge due to performance," consisting of a fairly detailed procedure to be used before an employee may be fired for cause. Preceding these definitions of the five categories of termination

is a section on “Policy,” the first sentence of which provides: “It is the policy of Hoffmann-La Roche to retain to the extent consistent with company requirements, the services of all employees who perform their duties efficiently and effectively.”

In 1976, plaintiff was promoted, and in January 1977 he was promoted again, this latter time to Group Leader for the Civil Engineering, the Piping Design, the Plant Layout, and the Standards and Systems Sections. In March 1978, plaintiff was directed to write a report to his supervisors about piping problems in one of defendant’s buildings in Nutley. This report was written and submitted to plaintiff’s immediate supervisor on April 5, 1978. On May 3, 1978, stating that the General Manager of defendant’s Corporate Engineering Department had lost confidence in him, plaintiff’s supervisors requested his resignation. Following this, by letter dated May 22, 1978, plaintiff was formally asked for his resignation, to be effective July 15, 1978.

Plaintiff refused to resign. Two weeks later defendant again requested plaintiff’s resignation, and told him he would be fired if he did not resign. Plaintiff again declined, and he was fired in July.

Plaintiff filed a complaint alleging breach of contract....The gist of plaintiff’s breach of contract claim is that the express and implied promises in defendant’s employment manual created a contract under which he could not be fired at will, but rather only for cause, and then only after the procedures outlined in the manual were followed. Plaintiff contends that he was not dismissed for good cause, and that his firing was a breach of contract.

Defendant’s motion for summary judgment was granted by the trial court, which held that the employment manual was not contractually binding on defendant, thus allowing defendant to terminate plaintiff’s employment at will. The Appellate Division affirmed. We granted certification.

The employer’s contention here is that the distribution of the manual was simply an expression of the company’s “philosophy” and therefore free of any possible contractual consequences. The former employee claims it could reasonably be read as an explicit statement of company policies intended to be followed by the company in the same manner as if they were expressed in an agreement signed by both employer and employees....

This Court has long recognized the capacity of the common law to develop and adapt to current needs....The interests of employees, employers, and the public lead to the conclusion that the common law of New Jersey should limit the right of an employer to fire an employee at will.

In order for an offer in the form of a promise to become enforceable, it must be accepted. Acceptance will depend on what the promisor bargained for: he may have bargained for a return promise that, if given, would result in a bilateral contract, both promises becoming enforceable. Or he may have bargained for some action or nonaction that, if given or withheld, would render his promise enforceable as a unilateral contract. In most of the cases involving an employer’s personnel policy manual, the document is prepared without any negotiations and is voluntarily distributed to the workforce by the employer. It seeks no return promise from the employees. It is reasonable to interpret it as seeking continued work from the employees, who, in most cases, are free to quit since they are almost always employees at will, not simply in the sense that the employer can fire them without cause, but in the sense that they can quit without breaching any obligation. Thus analyzed, the manual is an offer that seeks the formation of a unilateral contract—the employees’ bargained-for action needed to make the offer binding being their continued work when they have no obligation to continue.

The unilateral contract analysis is perfectly adequate for that employee who was aware of the manual and who continued to work intending that continuation to be the action in exchange for the employer’s promise; it is even more helpful in support of that conclusion if, but for the employer’s policy manual, the employee would have quit. See generally M. Petit, “Modern Unilateral Contracts,” 63 Boston Univ. Law Rev. 551 (1983) (judicial use of unilateral contract analysis in employment cases is widespread).

...All that this opinion requires of an employer is that it be fair. It would be unfair to allow an employer to distribute a policy manual that makes the workforce believe that certain promises have been made and then to allow the employer to renege on those promises. What is sought here is basic honesty: if the employer, for whatever reason, does not want the manual to be capable of being construed by the court as a binding contract, there are simple ways to attain that goal. All that need be done is the inclusion in a very prominent position of an appropriate statement that there is no promise of any kind by the employer contained in the manual; that regardless of what the manual says or provides, the employer promises nothing and remains free to change wages and all other working conditions without having to consult anyone and without anyone’s agreement; and that the employer continues to have the absolute power to fire anyone with or without good cause.

Reversed and remanded for trial.

CASE QUESTIONS

1. What did Woolley do to show his acceptance of the terms of employment offered to him?
2. In part of the case not included here, the court notes that Mr. Woolley died “before oral arguments on this case.” How can there be any damages if the plaintiff has died? Who now has any case to pursue?
3. The court here is changing the law of employment in New Jersey. It is making case law, and the rule here articulated governs similar future cases in New Jersey. Why did the court make this change? Why is it relevant that the court says it would be easy for an employer to avoid this problem?

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7.5: Summary and Exercises

Summary

Contract law developed as the status-centered organization of feudal society faded and people began to make choices about how they might order their lives. In the capitalistic system, people make choices about how to interact with others, and—necessarily—those choices expressed as promises must be binding and enforceable.

The two fundamental sources of contract law are (1) the common law as developed in the state courts and as summarized in the Restatement (Second) of Contracts and (2) the Uniform Commercial Code for the sale of goods. In general, the UCC is more liberal than the common law in upholding the existence of a contract.

Types of contracts can be distinguished by four criteria: (1) express and implied, including quasi-contracts implied by law; (2) bilateral and unilateral; (3) enforceable and unenforceable; and (4) completed (executed) and uncompleted (executory). To understand contract law, it is necessary to master these distinctions and their nuances.

EXERCISES

1. 1. Mr. and Mrs. Smith, an elderly couple, had no relatives. When Mrs. Smith became ill, the Smiths asked a friend, Henrietta, to help with various housekeeping chores, including cleaning and cooking. Although the Smiths never promised to pay her, Henrietta performed the chores for eighteen months. Henrietta now claims that she is entitled to the reasonable value of the services performed. Is she correct? Explain.
   2. Assume instead that the Smiths asked Mrs. Smith's sister, Caroline, who lived nearby, to help with the housekeeping. After eighteen months, Caroline claims she is entitled to the reasonable value of the services performed. Is she correct? Explain.
2. A letter from Bridge Builders Inc. to the Allied Steel Company stated, "We offer to purchase 10,000 tons of No. 4 steel pipe at today's quoted price for delivery two months from today. Your acceptance must be received in five days." Does Bridge Builders intend to create a bilateral or a unilateral contract? Why?
3. Roscoe's barber persuaded him to try a new hair cream called Sansfree, which the barber applied to Roscoe's hair and scalp. The next morning Roscoe had a very unpleasant rash along his hairline. Upon investigation he discovered that the rash was due to an improper chemical compound in Sansfree. If Roscoe filed a breach of contract action against the barber, would the case be governed by the Uniform Commercial Code or common law? Explain.
4. Rachel entered into a contract to purchase a 2004 Dodge from Hanna, who lived in the neighboring apartment. When a dispute arose over the terms of the contract, Hanna argued that, because neither she nor Rachel was a merchant, the dispute should be decided under general principles of common law. Rachel, on the other hand, argued that Hanna was legally considered to be a merchant because she sold the car for profit and that, consequently, the sale was governed by the Uniform Commercial Code. Who is correct? Explain.
5. Lee and Michelle decided to cohabit. When they set up house, Michelle gave up her career, and Lee promised to share his earnings with her on a fifty-fifty basis. Several years later they ended their relationship, and when Lee failed to turn over half of his earnings, Michelle filed suit on the basis of Lee's promise. What kind of contract would Michelle allege that Lee had breached? Explain.
6. Harry and Wilma were divorced in 2008, and Harry was ordered in the divorce decree to pay his ex-wife $10,000. In 2009 and 2010 Harry was hospitalized, incurring $3,000 in bills. He and Wilma discussed the matter, and Wilma agreed to pay the bill with her own money, even though Harry still owed her $5,000 from the divorce decree. When Harry died in late 2010, Wilma made a claim against his estate for $8,000 (the $3,000 in medical bills and the $5,000 from the decree), but the estate was only willing to pay the $5,000 from the decree, claiming she had paid the hospital bill voluntarily and had no contract for repayment. Is the estate correct? Explain.
7. Louie, an adult, entered into a contract to sell a case of scotch whiskey to Leroy, a minor. Is the contract void or voidable? Explain.
8. James Mann owned a manufacturing plant that assembled cell phones. A CPA audit determined that several phones were missing. Theft by one or more of the workers was suspected. Accordingly, under Mann's instructions, the following sign was placed in the employees' cafeteria:

   Reward. We are missing phones. I want all employees to watch for thievery. A reward of $500 will be paid for information

given by any employee that leads to the apprehension of employee thieves.

—James Mann

Waldo, a plant employee, read the notice and immediately called Mann, stating, "I accept your offer. I promise to watch other employees and provide you with the requested information." Has a contract been formed? Explain.

9. Almost every day Sally took a break at lunch and went to the International News Stand—a magazine store—to browse the newspapers and magazines and chat with the owner, Conrad. Often she bought a magazine. One day she went there, browsed a bit, and took a magazine off the rack. Conrad was busy with three customers. Sally waved the magazine at Conrad and left the store with it. What kind of a contract, if any, was created?
10. Joan called Devon Sand & Gravel and ordered two "boxes" (dump-truck loads) of gravel to be spread on her rural driveway by the "shoot and run" method: the tailgate is partially opened, the dump-truck bed is lifted, and the truck moves down the driveway spreading gravel as it goes. The driver mistakenly graveled the driveway of Joan's neighbor, Watson, instead of Joan's. Is Devon entitled to payment by Watson? Explain.

SELF-TEST QUESTIONS

1. An implied contract
    1. must be in writing
    2. is one in which the terms are spelled out
    3. is one inferred from the actions of the parties
    4. is imposed by law to avoid an unjust result
    5. may be avoided by one party
2. The Convention on Contracts for the International Sale of Goods is
    1. an annual meeting of international commercial purchasing agents.
    2. contract law used in overseas US federal territories
    3. a customary format or template for drafting contracts
    4. a kind of treaty setting out international contract law, to which the United States is a party
    5. the organization that develops uniform international law
3. An unenforceable contract is
    1. void, not a contract at all
    2. one that a court will not enforce for either side because of a rule of law
    3. unenforceable by one party but enforceable by the other
    4. one that has been performed by one party but not the other
    5. too indefinite to be valid
4. Betty Baker found a bicycle apparently abandoned near her house. She took it home and spent $150 repairing and painting it, after which Carl appeared and proved his ownership of it. Under what theory is Betty able to get reimbursed for her expenditures?
    1. express contract
    2. implied contract
    3. apparent or quasi-contract
    4. executory contract
    5. none: she will not get reimbursed
5. Alice discusses with her neighbor Bob her plan to hire Woodsman to cut three trees on her side of their property line, mentioning that she can get a good deal because Woodsman is now between jobs. Bob says, "Oh, don't do that. My brother is going to cut some trees on my side, and he can do yours too for free." Alice agrees. But Bob's brother is preoccupied and never does the job. Three weeks later Alice discovers Woodsman's rates have risen prohibitively. Under what theory does Alice have a cause of action against Bob?
    1. express contract
    2. promissory estoppel
    3. quasi-contract
    4. implied contract
    5. none: she has no cause of action against Bob

SELF-TEST AnswerS

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

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8: THE AGREEMENT

Learning Objectives

After reading this chapter, you should understand the following:

- What a contract offer is, and what proposals are not offers
- How an offer is communicated
- How definite the offer needs to be
- How long an offer is good for
- How an offer is accepted, who can accept it, and when acceptance is effective

At the heart of every contract is an offer. An offer is a proposal by one party to enter into an agreement on specific terms, but not every proposal rises to the level of a legally enforceable offer. In this section, we will explore what constitutes a valid offer and what kinds of statements or negotiations fall short. We will also examine how an offer must be communicated, how definite its terms must be, and how long it remains open. Finally, we will look at the rules of acceptance—who has the power to accept, how acceptance is made effective, and why timing matters in contract formation.

8.1: The Agreement in General

8.2: The Offer

8.3: The Acceptance

8.4: Cases

8.5: Summary and Exercises

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8.1: The Agreement in General

LEARNING OBJECTIVES

1. Understand what a contract is and why contracts are important.
2. Identify the basic elements needed to form a valid contract.

Introduction to Contract Formation

Contracts are the foundation of business and personal transactions in modern society. From purchasing a cup of coffee to negotiating a multimillion-dollar merger, contracts provide the structure that allows people and organizations to create enforceable promises. A contract is more than just an agreement between parties—it is a legally binding obligation that courts will recognize and enforce.

To establish a valid contract, several essential elements must be present. First, there must be a **mutual agreement**, sometimes described as a "meeting of the minds." This is typically shown through **offer** and **acceptance**, where one party proposes terms and the other party agrees to them. Second, the agreement must be supported by **consideration**, meaning each party exchanges something of legal value, whether money, goods, services, or a promise to act or refrain from acting.

Beyond these basics, there are other considerations that determine whether a contract is valid. The parties must have the **capacity** to contract, ensuring that they understand the nature and consequences of the agreement. The subject matter of the agreement must also be **legal**—courts will not enforce contracts for illegal activities. In addition, some contracts must comply with the **Statute of Frauds**, which requires that certain types of agreements, such as contracts for the sale of real estate, be in writing.

Together, these elements and considerations ensure that contracts are entered into knowingly, voluntarily, and with sufficient substance to be enforced by law. Understanding how these elements operate is the first step in analyzing whether an agreement is merely a promise or a binding legal contract.

KEY TAKEAWAY

Contracts are legally enforceable agreements that provide structure for both everyday transactions and complex business deals. At their core, contracts require **offer, acceptance, and consideration** to be valid. Beyond these basics, other factors such as **capacity, legality, and, in some cases, a written agreement** determine whether a contract can be enforced in court.

EXERCISES

1. When looking at an agreement, can I clearly identify the **offer, acceptance, and consideration** that make it a contract rather than just a casual promise?What is the relationship between "the emphasis laid on the ego and the individual will" in modern times (Williston) and the concept of the contractual agreement?

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8.2: The Offer

LEARNING OBJECTIVES

1. Know the definition of *offer*.
2. Understand the three essentials of an offer: intent, communication, and definiteness.
3. Know when an offer expires and can no longer be accepted.

Offer

Offer and acceptance may seem to be straightforward concepts, as they are when two people meet face-to-face. But in a commercial society, the ways of making offers and accepting them are nearly infinite. A retail store advertises its merchandise in the newspaper. A seller makes his offer by mail or over the Internet. A telephone caller states that his offer will stand for ten days. An offer leaves open a crucial term. An auctioneer seeks bids. An offeror gives the offeree a choice. All these situations can raise tricky questions, as can corresponding situations involving acceptances.

In contract law, an offer is a **manifestation of willingness to enter into a bargain**, so made as to justify another person in understanding that their assent will conclude the deal. To be legally valid, an offer must meet certain requirements. Courts look closely at whether the offeror genuinely intended to create a binding agreement, whether the terms of the proposal are clear enough to be enforceable, and whether the offeree actually received and understood the offer.

These requirements are summarized in three key elements:

- **Serious intent**
- **Definite and certain terms**
- **Communication to the offeree**

Serious Intent

The offeror must demonstrate serious intent to be bound. This is not measured by the offeror's private state of mind, but by the objective standard of what a reasonable person in the offeree's position would believe. Courts examine outward words and conduct, not hidden thoughts.

- **Valid Offer Example**: A car dealer tells a customer, "I'll sell you this car for $15,000." A reasonable person would view this as a serious offer.
- **Invalid Offer Example**: At a party, the same dealer jokes to a friend, "I'd sell you my car for a dollar." No reasonable person would treat this as an enforceable offer.

Proposals That Lack Intent

Certain types of statements do not qualify as valid offers because they lack the required intent.

- **Expressions of Opinion** – A doctor telling a patient, "You should feel better in a few days," or a mechanic saying, "This repair will cost about $500," is merely expressing an estimate, not making a binding promise.
- **Statements of Future Intent** – A business owner saying, "I plan to sell my delivery van for $10,000 next spring," is only stating a plan. By contrast, "I will sell you my van for $10,000, payable next Friday," is a definite offer.
- **Advertisements and Price Quotations** – Generally considered invitations to negotiate, not binding offers, because they usually lack essential terms (quantity, delivery, etc.). For example, a store's ad stating "Bicycles on sale for $800" is an invitation to buy, not an enforceable contract. However, courts sometimes treat ads as offers if the facts show otherwise, as in **Lefkowitz v. Great Minneapolis Surplus Store (Minn. 1957)**, where a store's "first come, first served" ad was held to be a valid, enforceable offer.
- **Invitations to Bid** – An auctioneer, for example, solicits offers from the crowd but does not make the initial offer themselves. Similarly, requests for bids on a construction project are invitations for others to make offers.

Definite and Certain Terms

For an offer to be valid under common law, its terms must be clear enough for a court to determine whether a breach occurred and to fashion a remedy. At minimum, the following must be specified:

- Identification of the parties
- Identification of the subject matter
- Consideration (the price or exchange)
- Time of payment, delivery, or performance
- **Invalid Example**: "I will sell you my car at a fair price soon." – too vague.
- **Valid Example**: "I will sell you my 2021 Toyota Camry for $18,000, payable June 1, with delivery that same day."

Communication to the Offeree

The offer must be **communicated** to the intended recipient. Until the offeree has knowledge of the offer, they have no power of acceptance.

- An individual cannot accept an offer they did not know about, even if they later perform the requested act.
- If an offer is directed to a specific person, only that person (or their authorized representative) has the legal ability to accept it.

Example: A company offers a reward for a lost dog. Only those who know of the reward before returning the dog can claim it. Someone who returns the dog without knowledge of the offer cannot later demand payment.

Starbucks Example: Who does Starbucks communicate to, and how? Starbucks communicates its offers (e.g., "Buy one, get one free" or "$1 off any iced latte today") to its customers through mobile apps, email marketing, in-store signs, and digital menus. These communications are directed to the public or to loyalty program members, creating the power of acceptance when a customer walks in and makes the purchase under the advertised terms.

The UCC Approach

The Uniform Commercial Code (UCC) provides a more flexible approach for contracts involving the sale of goods. Under UCC § 2-204(3), a contract does not fail for indefiniteness if the parties intended to make a contract and there is a reasonably certain basis for a remedy.

Missing terms (price, delivery time, payment) can be "gap-filled" by default UCC provisions. For example, if no price is specified, the UCC supplies a "reasonable price" at the time of delivery.

Output and Requirements Contracts – Valid under the UCC so long as they are made in good faith. A seller may agree to sell "all the widgets we produce," or a buyer may agree to purchase "all the widgets we need." However, neither party can demand quantities unreasonably disproportionate to past practice.

- **Example – Output Contract**: A farmer agrees to sell all the corn he produces in a season to a local mill. If he produces 10,000 bushels, the mill is obligated to buy them all.
- **Example – Requirements Contract**: A restaurant agrees to purchase all the flour it needs from one bakery. If the restaurant typically uses 500 pounds a week, it cannot suddenly demand 5,000 pounds without justification.

The UCC prioritizes **intent and commercial reasonableness** over strict formalities, allowing courts to enforce legitimate business agreements even when some terms are missing.

Termination of the Offer

An offer cannot remain open forever. Unless accepted, it may terminate in several ways:

- **Revocation by the offeror** – Effective if communicated before acceptance.
  - *Example*: A seller offers to sell a car but withdraws the offer before the buyer accepts.

    - **Exceptions**: Option contracts (promise to hold an offer open for consideration), firm offers under UCC (signed, written by a merchant, irrevocable for up to 3 months), unilateral contracts where performance has begun (partial performance creates an implied option).
- **Rejection by the offeree** – Once rejected, the offer is terminated unless renewed.
    - *Example*: A buyer rejects a $10,000 offer for a car; later acceptance is ineffective unless the seller renews the offer.
- **Counteroffer** – Rejects the original offer and creates a new one.
    - *Example*: Seller offers $10,000; buyer replies, "I'll pay $9,000." The $10,000 offer is terminated.
    - Under common law, this follows the "mirror image rule."
    - Under UCC § 2-207, additional terms may still form part of the contract in commercial transactions ("battle of the forms").
- **Lapse of time** – Either the time stated in the offer, or a "reasonable time" if none is specified.
    - *Example*: A stock offer left open for one day expires if not accepted before markets close.
- **Death or insanity of the offeror** – Terminates the offer before acceptance.
    - *Example*: If a seller dies before acceptance, the offer ends.
- **Destruction of subject matter** – If essential goods or property are destroyed before acceptance, the offer terminates.
    - *Example*: Seller offers to sell his car, but it is totaled in an accident before acceptance.
- **Postoffer illegality** – If a law is passed making the contract illegal, the offer terminates.
    - *Example*: An offer to sell herbal supplements ends when the FDA bans them.

Key Takeaway

An offer is the foundation of contract formation. To be valid, it must be communicated to the offeree, made with serious intent (judged by an objective standard), and contain definite terms that allow for enforcement.

Under the UCC, courts are more flexible and may enforce a contract despite missing terms, so long as intent to contract exists. Special categories like **output and requirements contracts** are enforceable if made in good faith and consistent with past practice.

Finally, offers are not eternal: they can terminate by revocation, rejection, counteroffer, lapse of time, death or incapacity, destruction of subject matter, or illegality.

EXERCISES

1. Why is it said an offer is a "manifestation" of willingness to enter into a contract? How could willingness be "manifested"?
2. Which kind of standard is used to determine whether a person has made an offer—subjective or objective?
3. If Sandra posts a written notice offering "to the kitchen staff at Coldwater Bay (Alaska) transportation to Seattle at the end of the fishing season," and if David, one of the maintenance workers, says to her, "I accept your offer of transportation to Seattle," is there a contract?
4. What are the seven ways an offer can terminate?

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8.3: The Acceptance

LEARNING OBJECTIVES

1. Define *acceptance*.
2. Understand who may accept an offer.
3. Know when the acceptance is effective.
4. Recognize when silence is acceptance.

Acceptance

Acceptance is the **voluntary act of the offeree** by which they demonstrate agreement to the terms of the offer. To be effective, acceptance must (1) be made by the person to whom the offer was directed (or their authorized representative), (2) mirror the terms of the offer, and (3) be communicated in the manner required or invited by the offer.

The **Restatement (Second) of Contracts § 32** provides that unless the offer clearly indicates otherwise, the offeree may accept either by **making a promise** or by **beginning performance**.

- **Example (promise)**: A seller offers to sell a bicycle for $200. The buyer responds, "I agree to buy it for $200." This constitutes acceptance by promise.
- **Example (performance)**: A seller offers $100 to anyone who mows her lawn. The act of beginning to mow the lawn constitutes acceptance through performance.

Who May Accept?

Only the **intended offeree** has the legal power to accept an offer. An offer creates a contractual power of acceptance that belongs solely to the person or group to whom it is directed.

- If an offer is made to a specific individual, only that person (or an authorized agent) may accept.
- If an offer is made to the public at large, such as a **reward offer**, then anyone who meets the stated conditions may accept.

Courts focus on the **intent of the offeror**: the offeror decides who is invited to form a contract.

- **Example (specific offeree)**: A homeowner offers to sell their house to Alice for $300,000. Only Alice—or her authorized agent—can accept. Bob cannot accept on Alice's behalf unless Alice has given him authority.
- **Example (offer to the public)**: A store advertises, "The first 50 customers tomorrow will receive a free gift." Any member of the public who qualifies as one of the first 50 customers has the power to accept.

Stipulations as to Acceptance

Because the **offeror is the "master of the offer,"** they may dictate how acceptance must be made.

- If the offeror **specifies the mode of acceptance** (e.g., return mail, fax, or email), then that method must be followed for acceptance to be valid.
- If the offeror does not specify, acceptance is effective when transmitted by any **reasonable method** under the circumstances—often the same means used to communicate the offer or a customary method in the industry.
- **Example**: If the offer states, "You must reply by email," a mailed letter would not constitute a valid acceptance.
- **Example**: If no mode is specified, responding by phone, email, or mail would typically be reasonable.

The Mailbox Rule

Timing plays a crucial role in contract law. The **Mailbox Rule** provides that an acceptance is effective once it is **dispatched** (e.g., placed in the mail, sent by courier, or transmitted electronically by an authorized method), even if the offeror has not yet received

it.

This protects the offeree from losing the benefit of the bargain due to postal delays or other issues beyond their control.

- **Important limits**:
  - The Mailbox Rule applies only to acceptances, not to rejections, counteroffers, or revocations (which are effective only when received).
  - The rule does not apply if the offeror specifies a different method or timing.
- **Example**: On Monday, a seller offers to sell equipment to a buyer. On Tuesday, the buyer mails an acceptance letter. On Wednesday, before receiving the letter, the seller attempts to revoke. Under the mailbox rule, the contract was formed on Tuesday when the acceptance was mailed.

"Mailbox Rule" and Mode of Acceptance

The effectiveness of acceptance depends not just on **timing** but also on the **mode** used.

- If the offer specifies a required mode (e.g., "Reply by overnight courier"), the offeree must comply. A different method may still create a contract, but only when the offeror actually receives it.
- If the offer does not specify, any reasonable method under the circumstances is sufficient.
- **Example (specified mode)**: A seller says, "Confirm by overnight courier." If the buyer mails a standard letter instead, the acceptance is valid only upon receipt, not dispatch.
- **Example (reasonable mode)**: If an offer simply says, "Let me know," a mailed acceptance is effective when sent under the mailbox rule, since mail is a reasonable means.

Figure 9.1

	When Sent	When Recieved
1. Offer		✓
2. Revocation of Offer		✓
3. Rejection		✓
4. Acceptance	If reasonable or by specified mode	If unreasonable or mode not specified or after rejection sent

When Is Communication Effective?

Electronic Communications

Electronic communications have become a dominant method of contract formation. Many agreements are negotiated by email, accepted through online portals, and "signed" electronically. Generally speaking, these changes in medium do not alter the underlying rules of contract law.

To bring clarity, the **Uniform Electronic Transactions Act (UETA)** was promulgated in 1999 and adopted by most states (including California). Its purpose was to remove barriers to electronic commerce by validating electronic records and signatures. Under the UETA:

- A record or signature may not be denied legal effect solely because it is in electronic form.
- A contract may not be denied enforceability solely because an electronic record was used in its formation.

- If a law requires a writing, an electronic record satisfies the law.
- If a law requires a signature, an electronic signature satisfies the law.

In short, contracts can be validly created online just as they are in person, so long as the essential elements of offer, acceptance, and consideration are present.

Online Acceptances: Click-On Agreements

A common form of online contract is the **click-on agreement** (also called "clickwrap"). These occur when a user accepts terms and conditions by clicking an "I Agree" or "Accept" button before accessing software, websites, or apps. Courts routinely uphold click-on agreements as long as the terms are clearly presented and the user has an opportunity to review them before accepting.

- **Example**: A user downloading a software update is required to click "I Agree" to the terms of service before installation proceeds. By clicking, the user manifests assent, creating an enforceable contract.

Shrink-Wrap Terms

Another digital-age issue involves **shrink-wrap licenses**, where terms are enclosed inside product packaging or embedded within the software itself. By opening the package, installing the software, or using the product, the buyer is deemed to have accepted the terms. Courts generally enforce shrink-wrap terms so long as they are reasonably communicated and the buyer has an opportunity to reject the goods and return them for a refund.

- **Example**: A consumer purchases computer software. Inside the box is a license agreement stating that by opening the package or using the software, the consumer agrees to the terms. If the consumer installs and uses the software without objection, a court will typically enforce the license agreement.

Case Law: *Specht v. Netscape Communications Corp.*

While click-on and shrink-wrap agreements are often enforced, **acceptance requires fair notice of terms**. In *Specht v. Netscape Communications Corp.* (2d Cir. 2002), users downloaded free software by clicking a "Download" button. The licensing terms—including an arbitration clause—were hidden below the button and not visible unless the user scrolled down. The court held there was **no valid acceptance** because a reasonably prudent Internet user would not have known of the terms before downloading. Assent requires meaningful notice, not hidden provisions.

Limits of the Mailbox Rule in Electronic Contracts

Electronic communications also complicate the **mailbox rule**. If an email or fax is sent but not received—or overlooked—the traditional rule that acceptance is effective on dispatch may not apply. Courts look closely at the facts to determine whether there was reasonable notice.

- **Example**: If a faxed acceptance is never delivered due to machine error, a court may find no contract was formed because the offeror never received effective notice.

Silence as Acceptance

General Rule: Silence is not acceptance. A party generally must make some affirmative manifestation of assent.

Exceptions (Restatement § 69):

1. The offeree takes offered services with a reasonable expectation of payment.
   - *Example*: A carpenter offers to fix a collapsing porch. The homeowner says nothing but allows him to proceed. Acceptance by silence creates an implied contract.
2. The offeror states silence may constitute acceptance, and the offeree intends to accept by remaining silent.
   - *Example*: A friend offers to sell her car for $4,000, adding, "If I don't hear from you, I'll assume you accept." If you remain silent intending to accept, a contract exists.

3. Prior dealings create a reasonable expectation that silence is acceptance.
    - *Example*: Justice Holmes's Massachusetts case—where repeated business dealings meant silence reasonably signified assent unless otherwise communicated.

KEY TAKEAWAY

Without an acceptance of an offer, no contract exists, and once an acceptance is made, a contract is formed. If the offeror stipulates how the offer should be accepted, so be it. If there is no stipulation, any reasonable means of communication is good. Offers and revocations are usually effective upon receipt, while an acceptance is effective on dispatch. The advent of electronic contracting has caused some modification of the rules: courts are likely to investigate the facts surrounding the exchange of offer and acceptance more carefully than previously. But the nuances arising because of the mailbox rule and acceptance by silence still require close attention to the facts.

EXERCISES

1. Rudy puts this poster, with a photo of his dog, on utility poles around his neighborhood: "$50 reward for the return of my lost dog." Carlene doesn't see the poster, but she finds the dog and, after looking at the tag on its collar, returns the dog to Rudy. As she leaves his house, her eye falls on one of the posters, but Rudy declines to pay her anything. Why is Rudy correct that Carlene has no legal right to the reward?
2. How has the UCC changed the common law's mirror image rule, and why?
3. When is an offer generally said to be effective? A rejection of an offer? A counteroffer?
4. How have modern electronic communications affected the law of offer and acceptance?
5. When is silence considered an acceptance?

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8.4: Cases

Objective Intention

Lucy v. Zehmer

84 S.E.2d 516 (Va. 1954)

Buchanan, J.

This suit was instituted by W. O. Lucy and J. C. Lucy, complainants, against A. H. Zehmer and Ida S. Zehmer, his wife, defendants, to have specific performance of a contract by which it was alleged the Zehmers had sold to W. O. Lucy a tract of land owned by A. H. Zehmer in Dinwiddie county containing 471.6 acres, more or less, known as the Ferguson farm, for $50,000. J. C. Lucy, the other complainant, is a brother of W. O. Lucy, to whom W. O. Lucy transferred a half interest in his alleged purchase.

The instrument sought to be enforced was written by A. H. Zehmer on December 20, 1952, in these words: "We hereby agree to sell to W. O. Lucy the Ferguson farm complete for $50,000.00, title satisfactory to buyer," and signed by the defendants, A. H. Zehmer and Ida S. Zehmer.

The answer of A. H. Zehmer admitted that at the time mentioned W. O. Lucy offered him $50,000 cash for the farm, but that he, Zehmer, considered that the offer was made in jest; that so thinking, and both he and Lucy having had several drinks, he wrote out "the memorandum" quoted above and induced his wife to sign it; that he did not deliver the memorandum to Lucy, but that Lucy picked it up, read it, put it in his pocket, attempted to offer Zehmer $5 to bind the bargain, which Zehmer refused to accept, and realizing for the first time that Lucy was serious, Zehmer assured him that he had no intention of selling the farm and that the whole matter was a joke. Lucy left the premises insisting that he had purchased the farm....

In his testimony Zehmer claimed that he "was high as a Georgia pine," and that the transaction "was just a bunch of two doggoned drunks bluffing to see who could talk the biggest and say the most." That claim is inconsistent with his attempt to testify in great detail as to what was said and what was done....

If it be assumed, contrary to what we think the evidence shows, that Zehmer was jesting about selling his farm to Lucy and that the transaction was intended by him to be a joke, nevertheless the evidence shows that Lucy did not so understand it but considered it to be a serious business transaction and the contract to be binding on the Zehmers as well as on himself. The very next day he arranged with his brother to put up half the money and take a half interest in the land. The day after that he employed an attorney to examine the title. The next night, Tuesday, he was back at Zehmer's place and there Zehmer told him for the first time, Lucy said, that he wasn't going to sell and he told Zehmer, "You know you sold that place fair and square." After receiving the report from his attorney that the title was good he wrote to Zehmer that he was ready to close the deal.

Not only did Lucy actually believe, but the evidence shows he was warranted in believing, that the contract represented a serious business transaction and a good faith sale and purchase of the farm.

In the field of contracts, as generally elsewhere, "We must look to the outward expression of a person as manifesting his intention rather than to his secret and unexpressed intention. The law imputes to a person an intention corresponding to the reasonable meaning of his words and acts."

At no time prior to the execution of the contract had Zehmer indicated to Lucy by word or act that he was not in earnest about selling the farm. They had argued about it and discussed its terms, as Zehmer admitted, for a long time. Lucy testified that if there was any jesting it was about paying $50,000 that night. The contract and the evidence show that he was not expected to pay the money that night. Zehmer said that after the writing was signed he laid it down on the counter in front of Lucy. Lucy said Zehmer handed it to him. In any event there had been what appeared to be a good faith offer and a good faith acceptance, followed by the execution and apparent delivery of a written contract. Both said that Lucy put the writing in his pocket and then offered Zehmer $5 to seal the bargain. Not until then, even under the defendants' evidence, was anything said or done to indicate that the matter was a joke. Both of the Zehmers testified that when Zehmer asked his wife to sign he whispered that it was a joke so Lucy wouldn't hear and that it was not intended that he should hear.

The mental assent of the parties is not requisite for the formation of a contract. If the words or other acts of one of the parties

have but one reasonable meaning, his undisclosed intention is immaterial except when an unreasonable meaning which he attaches to his manifestations is known to the other party.

"* * * The law, therefore, judges of an agreement between two persons exclusively from those expressions of their intentions which are communicated between them. * * *." [Citation]

An agreement or mutual assent is of course essential to a valid contract but the law imputes to a person an intention corresponding to the reasonable meaning of his words and acts. If his words and acts, judged by a reasonable standard, manifest an intention to agree, it is immaterial what may be the real but unexpressed state of his mind.

So a person cannot set up that he was merely jesting when his conduct and words would warrant a reasonable person in believing that he intended a real agreement.

Whether the writing signed by the defendants and now sought to be enforced by the complainants was the result of a serious offer by Lucy and a serious acceptance by the defendants, or was a serious offer by Lucy and an acceptance in secret jest by the defendants, in either event it constituted a binding contract of sale between the parties....

Reversed and remanded.

CASE QUESTIONS

1. What objective evidence was there to support the defendants' contention that they were just kidding when they agreed to sell the farm?
2. Suppose the defendants really did think the whole thing was a kind of joke. Would that make any difference?
3. As a matter of public policy, why does the law use an objective standard to determine the seriousness of intention, instead of a subjective standard?
4. It's 85 degrees in July and 5:00 p.m., quitting time. The battery in Mary's car is out of juice, again. Mary says, "Arrgh! I will sell this stupid car for $50!" Jason, walking to his car nearby, whips out his checkbook and says, "It's a deal. Leave your car here. I'll give you a ride home and pick up your car after you give me the title." Do the parties have a contract?

Advertisements as Offers

Lefkowitz v. Great Minneapolis Surplus Store

86 N.W.2d 689 (Minn. 1957)

Murphy, Justice.

This is an appeal from an order of the Municipal Court of Minneapolis denying the motion of the defendant for amended findings of fact, or, in the alternative, for a new trial. The order for judgment awarded the plaintiff the sum of $138.50 as damages for breach of contract.

This case grows out of the alleged refusal of the defendant to sell to the plaintiff a certain fur piece which it had offered for sale in a newspaper advertisement. It appears from the record that on April 6, 1956, the defendant published the following advertisement in a Minneapolis newspaper:

Saturday 9 A.M. Sharp

3 Brand New Fur Coats Worth to $100.00

First Come

First Served

$1 Each

[The $100 coat would be worth about $800 in 2010 dollars.] On April 13, the defendant again published an advertisement in the same newspaper as follows:

Saturday 9 A.M.

2 Brand New Pastel Mink 3-Skin Scarfs

Selling for. $89.50

Out they go Saturday. Each...$1.00

1 Black Lapin Stole Beautiful, worth $139.50...$1.00

First Come First Served

The record supports the findings of the court that on each of the Saturdays following the publication of the above-described ads the plaintiff was the first to present himself at the appropriate counter in the defendant's store and on each occasion demanded the coat and the stole so advertised and indicated his readiness to pay the sale price of $1. On both occasions, the defendant refused to sell the merchandise to the plaintiff, stating on the first occasion that by a "house rule" the offer was intended for women only and sales would not be made to men, and on the second visit that plaintiff knew defendant's house rules.

The trial court properly disallowed plaintiff's claim for the value of the fur coats since the value of these articles was speculative and uncertain. The only evidence of value was the advertisement itself to the effect that the coats were "Worth to $100.00," how much less being speculative especially in view of the price for which they were offered for sale. With reference to the offer of the defendant on April 13, 1956, to sell the "1 Black Lapin Stole * * * worth $139.50 * * *" the trial court held that the value of this article was established and granted judgment in favor of the plaintiff for that amount less the $1 quoted purchase price.

1. The defendant contends that a newspaper advertisement offering items of merchandise for sale at a named price is a "unilateral offer" which may be withdrawn without notice. He relies upon authorities which hold that, where an advertiser publishes in a newspaper that he has a certain quantity or quality of goods which he wants to dispose of at certain prices and on certain terms, such advertisements are not offers which become contracts as soon as any person to whose notice they may come signifies his acceptance by notifying the other that he will take a certain quantity of them. Such advertisements have been construed as an invitation for an offer of sale on the terms stated, which offer, when received, may be accepted or rejected and which therefore does not become a contract of sale until accepted by the seller; and until a contract has been so made, the seller may modify or revoke such prices or terms. [Citations]

   ...On the facts before us we are concerned with whether the advertisement constituted an offer, and, if so, whether the plaintiff's conduct constituted an acceptance.

   There are numerous authorities which hold that a particular advertisement in a newspaper or circular letter relating to a sale of articles may be construed by the court as constituting an offer, acceptance of which would complete a contract. [Citations]

   The test of whether a binding obligation may originate in advertisements addressed to the general public is "whether the facts show that some performance was promised in positive terms in return for something requested." 1 Williston, Contracts (Rev. ed.) s 27.

   The authorities above cited emphasize that, where the offer is clear, definite, and explicit, and leaves nothing open for negotiation, it constitutes an offer, acceptance of which will complete the contract....

   Whether in any individual instance a newspaper advertisement is an offer rather than an invitation to make an offer depends on the legal intention of the parties and the surrounding circumstances. [Citations] We are of the view on the facts before us that the offer by the defendant of the sale of the Lapin fur was clear, definite, and explicit, and left nothing open for negotiation. The plaintiff having successfully managed to be the first one to appear at the seller's place of business to be served, as requested by the advertisement, and having offered the stated purchase price of the article, he was entitled to performance on the part of the defendant. We think the trial court was correct in holding that there was in the conduct of the parties a sufficient mutuality of obligation to constitute a contract of sale.

2. The defendant contends that the offer was modified by a "house rule" to the effect that only women were qualified to receive the bargains advertised. The advertisement contained no such restriction. This objection may be disposed of briefly by stating that, while an advertiser has the right at any time before acceptance to modify his offer, he does not have the right, after acceptance, to impose new or arbitrary conditions not contained in the published offer. [Citations]

Affirmed.

CASE QUESTIONS

1. If the normal rule is that display advertisements in newspapers and the like are not offers, but rather invitations to make an offer, why was this different? Why did the court hold that this was an offer?
2. What is the rationale for the rule that a display ad is usually not an offer?
3. If a newspaper display advertisement reads, “This offer is good for two weeks,” is it still only an invitation to make an offer, or is it an offer?
4. Is a listing by a private seller for the sale of a trailer on Craigslist or in the weekly classified advertisements an offer or an invitation to make an offer?

Silence as Acceptance

Hobbs v.Massasoit Whip Co.

33 N.E. 495 (Mass. 1893)

Holmes, J.

This is an action for the price of eel skins sent by the plaintiff to the defendant, and kept by the defendant some months, until they were destroyed. It must be taken that the plaintiff received no notice that the defendant declined to accept the skins. The case comes before us on exceptions to an instruction to the jury that, whether there was any prior contract or not, if skins are sent to the defendant, and it sees fit, whether it has agreed to take them or not, to lie back, and to say nothing, having reason to suppose that the man who has sent them believes that it is taking them, since it says nothing about it, then, if it fails to notify, the jury would be warranted in finding for the plaintiff.

Standing alone, and unexplained, this proposition might seem to imply that one stranger may impose a duty upon another, and make him a purchaser, in spite of himself, by sending goods to him, unless he will take the trouble, and bear the expense, of notifying the sender that he will not buy. The case was argued for the defendant on that interpretation. But, in view of the evidence, we do not understand that to have been the meaning of the judge and we do not think that the jury can have understood that to have been his meaning. The plaintiff was not a stranger to the defendant, even if there was no contract between them. He had sent eel skins in the same way four or five times before, and they had been accepted and paid for. On the defendant’s testimony, it was fair to assume that if it had admitted the eel skins to be over 22 inches in length, and fit for its business, as the plaintiff testified and the jury found that they were, it would have accepted them; that this was understood by the plaintiff; and, indeed, that there was a standing offer to him for such skins.

In such a condition of things, the plaintiff was warranted in sending the defendant skins conforming to the requirements, and even if the offer was not such that the contract was made as soon as skins corresponding to its terms were sent, sending them did impose on the defendant a duty to act about them; and silence on its part, coupled with a retention of the skins for an unreasonable time, might be found by the jury to warrant the plaintiff in assuming that they were accepted, and thus to amount to an acceptance. [Citations] The proposition stands on the general principle that conduct which imports acceptance or assent is acceptance or assent, in the view of the law, whatever may have been the actual state of mind of the party—a principle sometimes lost sight of in the cases. [Citations]

Exceptions overruled.

CASE QUESTIONS

1. What is an eel, and why would anybody make a whip out of its skin?
2. Why did the court here deny the defendant’s assertion that it never accepted the plaintiff’s offer?
3. If it reasonably seems that silence is acceptance, does it make any difference what the offeree really intended?

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8.5: Summary and Exercises

Summary

Whether a legally valid contract was formed depends on a number of factors, including whether the parties reached agreement, whether consideration was present, and whether the agreement was legal. Agreement may seem like an intuitive concept, but intuition is not a sufficient guide to the existence of agreement in legal terms. The most common way of examining an agreement for legal sufficiency is by determining whether a valid offer and acceptance were made.

An offer is a manifestation of willingness to enter into a bargain such that it would be reasonable for another individual to conclude that assent to the offer would complete the bargain. Offers must be communicated and must be definite; that is, they must spell out terms to which the offeree can assent.

An important aspect of the offer is its duration. An offer can expire in any one of several ways: (1) rejection, (2) counteroffer, (3) acceptance with counteroffer, (4) lapse of time, (5) death or insanity of the offeror or destruction of an essential term, (6) illegality, and (7) revocation. No understanding of agreement is complete without a mastery of these conditions.

To constitute an agreement, an offer must be accepted.

The offeree must manifest his assent to the terms of the offer in a manner invited or required by the offer. Complications arise when an offer is accepted indirectly through correspondence. Although offers and revocations of offers are not effective until received, an acceptance is deemed accepted when sent if the offeree accepts in the manner specified by the offeror. But the nuances that arise because of the mailbox rule and acceptance by silence require close attention to the circumstances of each agreement.

EXERCISES

1. Sarah's student apartment was unfurnished. She perused Doug's List, an online classified ad service (for nonmerchants), and saw this advertisement: "Moving. For sale: a very nice brown leather couch, almost new, $600." There was an accompanying photo and contact information. Sarah e-mailed the contact, saying she wanted to buy the couch. Does Sarah have a contract with the seller? Explain.
2. Seller called Buyer on the telephone and offered to sell his used stereo. Buyer agreed to buy it without asking the price. The next day Buyer changed her mind and attempted to back out of the agreement. Do the parties have a contract? Explain.
3. On August 1, Ernie wrote to Elsie offering to sell Elsie his car for $7,600, and he promised to hold the offer open for ten days. On August 4 Ernie changed his mind; he sent Elsie a letter revoking the offer. On August 5 Elsie e-mailed Ernie, accepting the offer. Ernie's letter of revocation arrived on August 6. Is there a contract? Explain.
4. On August 1 Grover visited a local electronics shop to purchase a new television. He saw one he liked but wasn't sure if he could afford the $750. The store owner agreed to write up and sign an offer stating that it would be held open for ten days, which he did. On August 2 the owner changed his mind and sent Grover an e-mail revoking the offer, which Grover received immediately. On August 3 Grover sent a reply e-mail accepting the original offer. Is there a contract? Explain.
5. Acme Corporation sent the following letter, here set out in its entirety:

   January 2, 2012

   Acme Corporation

   We hereby offer you 100 Acme golden widgets, size 6. This offer will be good for 10 days.

   [Signed] Roberta Acme

   Owner, Acme Corporation

   Is this offer irrevocable for the time stated? Explain.

6. On November 26, Joe wrote to Kate offering to purchase a farm that she owned. Upon receiving the letter on November 28,

Kate immediately sent Joe a letter of acceptance. However, shortly after mailing the letter, Kate had second thoughts and called Joe to advise him that she was rejecting his offer. The call was made before Joe received the letter of acceptance. Has a contract been formed? Why?

7. On a busy day just before April 15, Albert Accountant received a call from a local car dealer. The dealer said, "Hi, Mr. Accountant. Now, while you have income from doing clients' taxes, I have an excellent offer for you. You can buy a new Buick Century automobile completely loaded for $36,000. Al, I know you're busy. If I don't hear from you by the end of the day, I'll assume you want the car." Albert, distracted, did not respond immediately, and the dealer hung up. Then followed an exhausting day of working with anxiety-ridden tax clients. Albert forgot about the conversation. Two days later a statement arrived from the dealer, with instructions on how Albert should pick up the car at the dealership. Is there a contract? Explain.
8. Mr. and Mrs. Mitchell, the owners of a small secondhand store, attended an auction where they bought a used safe for $50. The safe, part of the Sumstad estate, had a locked compartment inside, a fact the auctioneer mentioned. After they bought the safe, the Mitchells had a locksmith open the interior compartment; it contained $32,000 in cash. The locksmith called the police, who impounded the safe, and a lawsuit ensued between the Mitchells and the Sumstad estate to determine the ownership of the cash. Who should get it, and why?
9. Ivan Mestrovic, an internationally renowned artist, and his wife lived for years in a house in Indiana. Ivan died in 1982. His widow remained in the house for some years; upon her death the contents of the house were willed to her children. When the Wilkens bought the house from the estate, it was very cluttered. A bank representative (the executor of the estate) said, "You can clean it yourself and keep whatever items you want, or we—as executor of Mrs. Mestrovic's estate—will hire a rubbish removal service to dispose of it." The Wilkens opted to clean it up themselves, and amid the mess, behind sofas and in odd closets, were six apparently valuable paintings by Mestrovic. The estate claimed them; the Wilkens claimed them. Who gets the paintings, and why?
10. David Kidd's dog bit Mikaila Sherrod. On June 14, 2010, the Kidds offered to settle for $32,000. On July 12 the Sherrods sued the Kidds. On July 20 the Kidds bumped their offer up to $34,000. The suit was subject to mandatory arbitration, which proceeded on April 28, 2011. On May 5 the arbitrator awarded the Sherrods $25,000. On May 9 the Sherrods wrote to the Kidds and purported to accept their last offer of $34,000, made the year before. The Sherrods' attorney moved to enforce that purported $34,000 "settlement agreement." The court concluded that the offer was properly accepted because it had not been withdrawn and entered judgment against the Kidds for $34,000. The Kidds appealed. What result should obtain on appeal, and why?*Sherrod ex rel. Cantone v. Kidd*, 155 P.3d 976 (Wash. Ct. App., 2007).

SELF-TEST QUESTIONS

1. In interpreting agreements for the purpose of establishing whether a valid contract exists, courts generally apply
    1. subjective standards
    2. objective standards
    3. either a subjective or an objective standard
    4. none of the above
2. A valid offer must be
    1. written
    2. written and intended
    3. communicated by letter
    4. communicated and definite
3. An offer
    1. must specify time, place, and manner of acceptance
    2. must be accepted immediately to be valid
    3. need not be accepted immediately
    4. can only be accepted by the same means it was made
4. An offer generally
    1. is rejected by a counteroffer
    2. can be revoked if the offeror changes his or her mind
    3. can lapse after a reasonable period of time
    4. involves all of the above
5. An acceptance is generally considered effective
    1. when a letter is received by the offeror
    2. when a letter is mailed
    3. when the offeree is silent
    4. only when the acceptance is transmitted in writing

SELF-TEST AnswerS

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

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9: CONSIDERATION

Learning Objectives

After reading this chapter, you should understand the following:

1. What “consideration” is in contract law, what it is not, and what purposes it serves
2. How the sufficiency of consideration is determined
3. In what common situations an understanding of consideration is important
4. What promises are enforceable without consideration

9.1: General Perspectives on Consideration

9.2: Legal Sufficiency

9.3: Promises Enforceable without Consideration

9.4: Cases

9.5: Summary and Exercises

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9.1: General Perspectives on Consideration

LEARNING OBJECTIVES

1. Understand what “consideration” is in contract law.
2. Recognize what purposes the doctrine serves.
3. Understand how the law determines whether consideration exists.
4. Know the elements of consideration.

The Purpose of Consideration

This chapter continues our inquiry into whether the parties created a valid contract. In the previous chapters, we saw that the first requisite of a valid contract is an agreement: offer and acceptance. In this chapter, we assume that agreement has been reached and concentrate on one of its crucial aspects: the existence of consideration. Which of the following, if any, is a contract?

1. Betty offers to give a book to Lou. Lou accepts.
2. Betty offers Lou the book in exchange for Lou’s promise to pay twenty-five dollars. Lou accepts.
3. Betty offers to give Lou the book if Lou promises to pick it up at Betty’s house. Lou agrees.

In American law, only the second situation is a binding contract, because only that contract contains **consideration**, a set of mutual promises in which each party agrees to give up something to the benefit of the other. This chapter will explore the meaning and rationale of that statement.

The question of what constitutes a binding contract has been answered differently throughout history and in other cultures. For example, under Roman law, a contract without consideration was binding if certain formal requirements were met. And in the Anglo-American tradition, the presence of a seal—the wax impression affixed to a document—was once sufficient to make a contract binding without any other consideration. The seal is no longer a substitute for consideration, although in some states it creates a presumption of consideration; in forty-nine states, the Uniform Commercial Code (UCC) has abolished the seal on contracts for the sale of goods. (Louisiana has not adopted UCC Article 2.)

Whatever its original historical purposes, and however apparently arcane, the doctrine of consideration serves some still-useful purposes. It provides objective evidence for asserting that a contract exists; it distinguishes between enforceable and unenforceable bargains; and it is a check against rash, unconsidered action, against thoughtless promise making.Lon L. Fuller, “Consideration and Form,” *Columbia Law Review* 41 (1941): 799.

A Definition of *Consideration*

Consideration is said to exist when the promisor receives some benefit for his promise and the promisee gives up something in return; it is the bargained-for price you pay for what you get. That may seem simple enough. But as with much in the law, the complicating situations are never very far away. The “something” that is promised or delivered cannot be just anything, such as a feeling of pride, warmth, amusement, or friendship; it must be something known as a **legal detriment**—an act, forbearance, or a promise of such from the promisee. The detriment need not be an actual detriment; it may in fact be a benefit to the promisee, or at least not a loss. The detriment to one side is usually a **legal benefit** to the other, but the detriment to the promisee need not confer a tangible benefit on the promisor; the promisee can agree to forego something without that something being given to the promisor. Whether consideration is legally sufficient has nothing to do with whether it is morally or economically adequate to make the bargain a fair one. Moreover, legal consideration need not even be certain; it can be a promise contingent on an event that may never happen. Consideration is a legal concept, and it centers on the giving up of a legal right or benefit.

Consideration has two elements. The first, as just outlined, is whether the promisee has incurred a **legal detriment**—given up something, paid some “price,” though it may be, for example, the promise to do something, like paint a house. (Some courts—although a minority—take the view that a bargained-for legal benefit to the promisor is sufficient consideration.) The second element is whether the legal detriment was bargained for (**bargained-for exchange**): did the promisor specifically intend the act, forbearance, or promise in return for his promise? Applying this two-pronged test to the three examples given at the outset of the chapter, we can easily see why only in the second is there legally sufficient consideration. In the first, Lou incurred

no legal detriment; he made no pledge to act or to forbear from acting, nor did he in fact act or forbear from acting. In the third example, what might appear to be such a promise is not really so. Betty made a promise on a condition that Lou comes to her house; the intent clearly is to make a gift.

Legal Detriment

A *legal detriment* occurs when a party either:

1. **Does something they are not legally obligated to do**, OR
2. **Refrains from doing something they have a legal right to do.**

Examples:

- **Promise to Pay:** Alice promises to pay Bob $100 if Bob walks across the Brooklyn Bridge. Bob incurs a *legal detriment* by doing something he was not previously obligated to do (walking across the bridge).
- **Promise to Refrain:** Charlie promises to stop smoking for one year if Dana pays him $1,000. Charlie has given up a legal right (smoking) and thus suffers a *legal detriment*.
- **Employment Contract:** An employee agrees to work for 40 hours a week for wages. The employee gives up their legal right to not work (detriment) and the employer gives up their money (detriment).

Bargained-for Exchange

The *bargained-for exchange* requirement means that the **promisor's promise induces the promisee's detriment, and the promisee's detriment induces the promisor's promise.** In other words, each side's action or forbearance must be the *price* of the other's promise.

Examples:

- **Sale of Goods:** Ellen promises to sell her car to Frank for $5,000, and Frank promises to pay $5,000. Ellen's detriment (giving up the car) was bargained for in exchange for Frank's detriment (paying money).
- **Services Contract:** A painter agrees to paint a homeowner's house for $3,000. The homeowner's promise to pay is the *bargained-for exchange* for the painter's promise to paint.
- **Settlement Agreement:** In a lawsuit, Plaintiff agrees to dismiss their claim (detriment) if Defendant pays $10,000 (detriment). Each side is giving something up in a bargained-for exchange.

KEY TAKEAWAY

Consideration is—with some exceptions—a required element of a contract. It is the bargained-for giving up of something of legal value for something in return. It serves the purposes of making formal the intention to contract and reducing rash promise making.

EXERCISES

1. Alice promises to give her neighbor a blueberry bush; the neighbor says, "Thank you!" Subsequently, Alice changes her mind. Is she bound by her promise?
2. Why, notwithstanding its relative antiquity, does consideration still serve some useful purposes?
3. Identify the exchange of consideration in this example: A to B, "I will pay you $800 if you paint my garage." B to A, "Okay, I'll paint your garage for $800."

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9.2: Legal Sufficiency

LEARNING OBJECTIVES

1. Know in general what “legal sufficiency” means when examining consideration.
2. Recognize how the concept operates in such common situations as threat of litigation, and accord and satisfaction.
3. Understand why illusory promises are unenforceable, and how courts deal with needs, outputs, and exclusive dealings contracts.

The Concept of Legal Sufficiency

As suggested in Section 9.1, what is required in contract is the exchange of a legal detriment and a legal benefit; if that happens, the consideration is said to have **legal sufficiency**.

Actual versus Legal Detriment

Suppose Phil offers George $500 if George will quit smoking for one year. Is Phil’s promise binding? Because George is presumably benefiting by making and sticking to the agreement—surely his health will improve if he gives up smoking—how can his act be considered a legal detriment? The answer is that there is forbearance on George’s part: George is legally entitled to smoke, and by contracting not to, he suffers a loss of his legal right to do so. This is a legal detriment; consideration does not require an actual detriment.

Adequacy of Consideration

Definition

The doctrine of **adequacy of consideration** concerns whether the value exchanged in a contract is *fair* or *proportionate*. Under traditional contract law, courts do not evaluate the adequacy of consideration—meaning they do not ask whether the parties made a “good deal” or a “bad deal.” As long as **legal consideration** exists (something of value, or a legal detriment exchanged), the courts generally enforce the contract, even if the bargain seems unfair or one-sided.

Rationale

The reasoning is rooted in the principle of **freedom of contract**. Courts assume that competent parties are best positioned to evaluate their own interests and to decide whether an exchange is beneficial. Thus, a contract will not be voided merely because one party pays too much or receives too little, provided the consideration is legally sufficient.

Illustrative Example

- **Example 1:** If A agrees to sell B a car worth $20,000 for $500, courts will not declare the contract void solely because the consideration seems inadequate. The fact that B provides some value ($500) is sufficient consideration.
- **Example 2:** A agrees to work for B for $1 per day. Even though this seems grossly inadequate, the law recognizes it as consideration, unless there is evidence of fraud, duress, or unconscionability.

Limitations

While adequacy itself is not usually a concern, courts may intervene when the exchange is so **grossly inadequate** that it suggests another legal issue, such as:

- **Fraud or misrepresentation**: one party was misled into agreeing.

- **Duress or undue influence**: one party lacked free will in bargaining.
- **Unconscionability**: the terms are so one-sided that enforcing them would be unjust.

Case Example: *Batsakis v. Demotsis* (1949)

During World War II, Demotsis promised to repay $2,000 plus interest in exchange for a loan of 500,000 drachmae (worth about $25). She later argued the consideration was inadequate. The court upheld the contract, reasoning that **"mere inadequacy of consideration will not void a contract"**—as long as some legal detriment was exchanged.

Settlement of Claims

This section discusses several common circumstances where the issue of whether the consideration proffered (offered up) is adequate.

Threat of Litigation: Covenant Not to Sue

A **covenant not to sue** is a contractual agreement in which one party agrees **not to pursue a legal claim** against another, typically in exchange for some form of consideration. Unlike a release, which immediately discharges a claim, a covenant not to sue suspends or substitutes the right to litigate with a promise not to exercise that right.

Nature of the Agreement

- **Contractual Promise:** A covenant not to sue is itself a contract and therefore requires consideration to be enforceable.
- **Alternative to Litigation:** It allows parties to resolve disputes without proceeding to court, substituting contractual remedies for litigation.
- **Preservation of the Claim:** Unlike a release that extinguishes the underlying claim, a covenant not to sue does not eliminate the cause of action but rather creates a contractual obligation not to bring it.

Examples

1. **Settlement of a Dispute:** A consumer claims a product caused injury. The manufacturer agrees to pay $10,000, and the consumer agrees not to sue. The covenant not to sue prevents the consumer from filing a lawsuit if the payment is made.
2. **Business Agreements:** Two companies in conflict over a trademark agree that one will pay licensing fees, and in return, the other agrees not to sue for infringement.
3. **Employment Context:** An employee settles a wrongful termination claim with the employer. In exchange for severance, the employee agrees not to sue.

Legal Effect

- If the party who covenanted not to sue later brings a lawsuit, the other party can raise the covenant as a **defense** and may also sue for **breach of contract**.
- Courts treat covenants not to sue as valid consideration, because the party agreeing to forbear from exercising a legal right suffers a **legal detriment**.

Case Example: *Fiege v. Boehm* (1956)

Boehm agreed not to bring a bastardy proceeding against Fiege if he agreed to support her child. Although it was later proven Fiege was not the father, the court held the covenant not to sue was valid consideration because Boehm had a **reasonable, good-faith belief** in her claim.

Accord and Satisfaction Generally

Accord and satisfaction is a legal method of discharging a contractual obligation through the substitution of a new agreement

and its performance. The "accord" is the agreement in which one party agrees to accept something different, often less, than what was originally promised, while the "satisfaction" is the execution of that agreement. Together, these two elements resolve the original obligation. To be valid, there must be a genuine dispute over the amount or nature of the debt, an agreement to settle that dispute by accepting substitute performance, and performance of the accord. For example, if Alice claims Bob owes her $5,000 and Bob insists he only owes $3,000, they may agree that Alice will accept $3,500 as full payment. Once Bob pays, the original obligation is discharged. Similarly, if a business receives a check for less than the invoiced amount marked "Paid in Full," cashing the check in the context of a genuine dispute may amount to accord and satisfaction. However, this doctrine does not apply to undisputed debts—payment of a lesser sum generally cannot discharge the whole without additional consideration. Courts also require that such agreements be made in good faith; a manufactured dispute will not suffice. A well-known case, *Foakes v. Beer* (1884), illustrates this limitation: the court held that part payment of an undisputed debt, without more, does not release the debtor from the entire obligation. Accord and satisfaction remains an important tool for resolving disputes efficiently, allowing parties to substitute negotiated settlement for litigation.

Examples

- **Disputed Debt:** Alice claims Bob owes her $5,000. Bob argues he only owes $3,000. They agree Alice will accept $3,500 as full payment. When Bob pays, the debt is discharged through accord and satisfaction.
- **Check Marked "Paid in Full":** A business receives a check from a customer for less than the invoiced amount, with "Paid in Full" written on it. If the business knowingly cashes the check in the context of a genuine dispute, it may constitute accord and satisfaction.
- **Service Contract:** A painter agrees to paint a house for $10,000. The homeowner is dissatisfied with the work and disputes the amount owed. The parties agree that the homeowner will pay $7,500 instead, and the painter will accept that as full payment.

Limitations

- **No Dispute, No Accord:** If the obligation is liquidated (fixed and undisputed), payment of a lesser sum generally cannot discharge the full debt without additional consideration.
- **Good Faith Required:** The dispute and settlement must be genuine. Bad faith attempts to evade payment will not create a valid accord and satisfaction.

Settling an Unliquidated Debt

A **liquidated debt** is one whose amount is certain, fixed, and undisputed. Because the obligation is clear, partial payment of a liquidated debt—such as paying $800 on a $1,000 loan—does not generally discharge the entire obligation unless there is additional consideration, such as early payment or payment in a different form. By contrast, an **unliquidated debt** is one whose existence or amount is uncertain, often due to disagreement about the quality of services, the scope of work performed, or the value of goods delivered. In these situations, the parties may compromise by negotiating a new agreement, typically through **accord and satisfaction**, in which the creditor accepts a lesser or different amount and the debtor fulfills that promise, thereby discharging the claim. For example, if a contractor bills a homeowner $12,000 for remodeling work but the homeowner disputes the quality and believes the work is worth only $8,000, the parties may settle on $9,500 as full payment. Once that payment is made, the debt is extinguished. Courts encourage the settlement of unliquidated debts because the compromise itself provides consideration: each party gives up the right to contest the dispute further.

Settling a Disputed Debt

A **disputed debt** arises where the parties *did* agree on (liquidated) the price or fee but subsequently get into a dispute about its fairness, and then settle. When this dispute is settled, the parties have given consideration to an agreement to accept a fixed sum as payment for the amount due. Assume that in the gallbladder case the patient agrees in advance to pay $8,000. Eight months after the operation and as a result of nausea and vomiting spells, the patient undergoes a second operation; the surgeons discover a surgical sponge embedded in the patient's intestine. The patient refuses to pay the full sum of the original surgeon's bill; they settle on $6,000, which the patient pays. This is a binding agreement because subsequent facts arose to make legitimate the patient's quarrel over his obligation to pay the full bill. As long as the dispute is based in fact and is not trumped up, as long as the promisee is acting in good faith, then consideration is present when a disputed debt is settled.

Release

A **release** is a contractual agreement in which one party surrenders the right to pursue a legal claim against another, usually in exchange for consideration such as money, services, or some other benefit. Unlike a covenant not to sue, which merely creates a promise not to bring a lawsuit, a release immediately extinguishes the underlying claim. Because it is a contract, a valid release requires the essential elements of contract formation, including consideration and voluntary consent. For example, an injured driver may sign a release in exchange for an insurance settlement payment, agreeing that the payment fully satisfies all claims arising from the accident. Once the release is executed, the injured party cannot later bring a lawsuit based on the same event. Courts generally enforce releases unless they were obtained through fraud, duress, or misrepresentation, or if the language of the release is overly broad and against public policy. In this way, a release serves as a powerful risk-management tool, allowing parties to achieve finality and avoid litigation by contractually resolving disputes.

Agreements That Lack Consideration

Preexisting Duty

The **preexisting duty rule** provides that a promise to do something one is already legally obligated to do does not constitute valid consideration for a new contract. Because consideration requires a legal detriment or a bargained-for exchange, performing (or promising to perform) an existing obligation does not create new value. For example, if a police officer promises to apprehend a suspect in exchange for a reward, the promise is unenforceable because the officer already has a legal duty to perform that task. Similarly, if a contractor agrees to build a house for $200,000 and later demands an additional $20,000 to finish the work, the promise to complete the house is not valid consideration because the contractor was already obligated under the original contract.

There are, however, several **important exceptions** to this rule:

1. **Unforeseen Difficulties:** If a party encounters extraordinary and unforeseeable difficulties that were not anticipated when the contract was made, a promise for additional compensation may be enforceable. For instance, if a contractor unexpectedly discovers hazardous materials that must be removed before construction can continue, the additional payment may be valid consideration.
2. **Rescission and New Contract:** If the parties mutually agree to cancel (rescind) the original contract and then enter into a new one, the obligations under the new agreement are supported by fresh consideration.
3. **Modification under the UCC:** In contracts for the sale of goods, the Uniform Commercial Code (UCC) provides that modifications do not require additional consideration, as long as the modification is made in **good faith**. This exception recognizes the dynamic nature of commercial transactions and allows flexibility in adjusting contract terms.

These exceptions balance the rigidity of the preexisting duty rule by ensuring fairness and practicality, while still protecting parties from being coerced into paying more for obligations already owed.

Past Consideration

Definition:
Past consideration refers to an act or benefit already performed or conferred before a promise is made. Because the performance did not occur as part of a bargained-for exchange, it does not qualify as valid consideration. In other words, consideration must be **contemporaneous** with the promise—both sides must exchange value at the time of contracting, not retroactively.

Rule:
The rule is often summed up as: **"Past consideration is no consideration."**
A promise to compensate someone for a past act or service, no matter how beneficial, is unenforceable because the performance was not induced by the promise.

Examples:

1. A student helps a professor move offices voluntarily. Afterward, the professor promises to pay $100. The promise is unenforceable because the work occurred before the promise.
2. A neighbor repairs a broken fence without agreement. Later, the homeowner promises to pay for the repair. Since the act was

completed before the promise, there is no enforceable contract.
3. A business partner says, "Because you worked so hard last year, I'll give you a bonus this year." Because the work was already completed, no valid consideration supports the promise.

Case Illustration – Mills v. Wyman (1825):
A man cared for an adult son who was seriously ill. After the son died, the father promised to pay the caretaker for his services. The court refused to enforce the promise, holding that caring for the son was a past action that could not support a contract. The father's moral obligation was insufficient without bargained-for consideration.

Case Illustration – Roscorla v. Thomas (1842):
A buyer purchased a horse. After the sale, the seller promised that the horse was "sound and free from vice." When the horse later turned out to be vicious, the court held the promise unenforceable: the sale had already occurred, so there was no new consideration for the later promise.

Rationale:
Courts require a **present exchange of value** to distinguish legally binding contracts from casual or moral promises. If past actions could serve as consideration, parties would constantly face unexpected obligations for benefits already conferred. The law instead enforces only those promises made **in exchange** for something of value.

Policy Consideration:
While past consideration cannot create an enforceable contract, some jurisdictions allow for exceptions when strong moral obligations exist, such as promises to repay debts barred by the statute of limitations (see next section: *Promise Revised after Statute of Limitations has Passed*) or debts discharged in bankruptcy. But these are recognized as **special categories**, not general rules.

Illusory Promises

An **illusory promise** is a statement that appears to be a promise but, upon closer examination, does not actually bind the promisor to any obligation. Because consideration requires a definite and enforceable commitment, an illusory promise fails as consideration and cannot form the basis of a valid contract. For instance, if an employer tells an employee, *"You will receive a bonus if I feel like it,"* the promise is illusory because the employer has complete discretion and no genuine obligation. Likewise, if a seller agrees to supply goods only *"if I choose to,"* the agreement lacks mutuality and is unenforceable. Another common example is when a landlord says, *"I might rent you the apartment if I decide to,"* which does not impose any real duty on the landlord.

There are, however, **important exceptions**. Courts and statutes recognize that certain contracts, although seemingly flexible, are enforceable because they carry an implied duty of good faith. Under the **Uniform Commercial Code (UCC)**, both **requirements contracts** (where a buyer agrees to purchase all the goods they require from a seller) and **output contracts** (where a seller agrees to sell all of their production to a buyer) are valid. At first glance, these agreements might appear illusory—since a buyer could claim to "require nothing" or a seller might "produce nothing." Yet, the law prevents abuse by imposing a duty of good faith. This means that in a requirements contract, the buyer must order goods consistent with actual business needs, and in an output contract, the seller must deliver production consistent with usual or expected output.

Thus, while illusory promises generally fail as consideration because they lack enforceability, **requirements and output contracts serve as clear exceptions**, showing how the law balances commercial flexibility with the principle of good faith.

Contrasting Illusory and Enforceable Promises

To better understand the concept, it is useful to contrast **illusory promises**, which fail for lack of consideration, with **enforceable promises** that satisfy contract requirements:

- **Illusory Promises (Not Enforceable):**
    - "I will buy your car if I feel like it."
      Illusory because performance is left entirely to the promisor's discretion.
    - "I promise to pay you $500 if I decide it's worth it."
      No true obligation exists; performance depends solely on whim.

- “I’ll think about hiring you if I want to.”
  Fails as a promise because no enforceable duty is created.

- **Enforceable Promises (Valid Consideration):**

  - “I will buy your car for $10,000 if my mechanic confirms it passes inspection.”
    Valid because performance depends on an objective condition, not mere discretion.

  - “I will buy all the steel I need for my factory from your company this year.” (*requirements contract*)
    Valid under the UCC because the buyer’s needs must be determined in good faith.

  - “I will sell you all the widgets my factory produces this month.” (*output contract*)
    Valid under the UCC because the seller must deliver actual output in good faith.

KEY TAKEAWAY

Courts do not inquire into the adequacy of consideration, but (with some exceptions) do require the promisor to incur a legal detriment (the surrender of any legal right he or she possesses—to give up something) in order to receive the bargained-for benefit. The surrender of the right to sue is a legal detriment, and the issue arises in analyzing various kinds of dispute settlement agreements (accord and satisfaction): the obligation to pay the full amount claimed by a creditor on a liquidated debt, an unliquidated debt, and a disputed debt. Where unforeseen difficulties arise, an obligor will be entitled to additional compensation (consideration) to resolve them either because the contract is modified or because the parties have entered into a novation, but no additional consideration is owing to one who performs a preexisting obligation or forbears from performing that which he or she is under a legal duty not to perform. If a promisor gives an illusory promise, he or she gives no consideration and no contract is formed; but exclusive dealing agreements, needs contracts, and outputs contracts are not treated as illusory.

EXERCISES

1. What is meant by “legally sufficient” consideration?
2. Why do courts usually not “inquire into the adequacy of consideration”?
3. How can it be said there is consideration in the following instances: (a) settlement of an unliquidated debt? (b) settlement of a disputed debt? (c) a person agreeing to do more than originally contracted for because of unforeseen difficulties? (d) a creditor agreeing with other creditors for each of them to accept less than they are owed from the debtor?
4. Why is there no consideration where a person demands extra compensation for that which she is already obligated to do, or for forbearing to do that which she already is forbidden from doing?
5. What is the difference between a contract modification and a novation?
6. How do courts resolve the problem that a needs or outputs contract apparently imposes no detriment—no requirement to pass any consideration to the other side—on the promisor?

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9.3: Promises Enforceable without Consideration

LEARNING OBJECTIVE

1. Understand the exceptions to the requirement of consideration.

For a variety of policy reasons, courts will enforce certain types of promises even though consideration may be absent. Some of these are governed by the Uniform Commercial Code (UCC); others are part of the established common law.

Promises Enforceable without Consideration at Common Law

At common law, the general rule is that **a contract must be supported by consideration**—a bargained-for exchange of value. Without consideration, promises are ordinarily unenforceable. But over time, courts and legislatures have recognized exceptions. Certain promises, though lacking traditional consideration, may still be enforced to prevent injustice, promote reliance, or uphold social and commercial expectations.

Promise Revived after Statute of Limitations Has Passed

Definition:
The statute of limitations sets the maximum period in which a creditor may bring a lawsuit to enforce a debt. Once the statute runs, the debtor has a legal defense against collection, and the debt becomes unenforceable in court. However, if the debtor later makes a new promise to pay—either expressly or impliedly—the obligation can be revived, even without new consideration.

Rule:
Although past consideration is usually invalid, courts recognize a debtor's new promise to pay as creating a fresh obligation, based on the **moral duty** arising from the original debt. This operates as an exception to the rule that "past consideration is no consideration."

How Revival Occurs:

1. **Written Promise to Repay** – If a debtor signs a new written promise after the statute has expired, most courts treat this as binding.
   - Example: After the statute runs on a $10,000 loan, the debtor emails the creditor: "I know I still owe you money and will start repaying next month." This revives the debt.
2. **Partial Payment** – Even a small payment after expiration can serve as acknowledgment of the debt, reviving the entire obligation.
   - Example: Sam owes $5,000. The statute of limitations passes. He then mails a $200 check with the note, "Here's the first payment." The law treats this as acknowledgment and revival of the full debt.
3. **Oral Promise** – Some jurisdictions allow revival through oral acknowledgment or promise, but many states require that the new promise be in **writing** and **signed** by the debtor to prevent fraudulent claims.

Case Illustration – Shoemaker v. Benedict (N.Y. 1854):
A debtor's promise to pay a debt barred by the statute of limitations was enforced even without new consideration. The court reasoned that the new promise reaffirmed the moral obligation of the original debt, thus creating a fresh contractual duty.

Case Illustration – Bankruptcy Context:
A debtor discharged in bankruptcy may later choose to voluntarily repay. Courts uphold this, not because the creditor can compel payment, but because the debtor's **new promise** creates a fresh enforceable duty.

Rationale:

- Encourages honesty and repayment of just debts.

- Balances the protection of debtors (through statutes of limitations) with creditors' rights when debtors voluntarily reaffirm obligations.
- Prevents debtors from using statutes of limitations as a permanent escape when they later acknowledge a debt.

Limitations:

- Jurisdictions vary: some require a **signed writing**; others accept oral promises or partial payments.
- The new promise revives only the acknowledged debt; it does not extend to unrelated obligations.
- If the debtor makes a vague statement (e.g., "I'll pay you someday"), courts may find it too indefinite to revive the obligation.

Promissory Estoppel (Detrimental Reliance)

Definition:
Promissory estoppel is a doctrine that allows courts to enforce a promise, even without consideration, when one party reasonably relies on the promise to their detriment. It exists to prevent injustice in situations where strict adherence to the requirement of consideration would lead to an unfair result.

Rule:
A promise becomes enforceable under promissory estoppel when three elements are met:

1. The promise is one that the promisor should reasonably expect to induce reliance.
2. The promisee takes action (or refrains from acting) in reliance on the promise.
3. Injustice can only be avoided by enforcing the promise.

This is sometimes called **"promissory estoppel with detrimental reliance."**

Case Example – Estate of Timko v. Oral Roberts Evangelistic Assn. (Mich. App. 1974):

- Timko, a trustee of a school, promised to contribute funds to help purchase a building.
- The school relied on his promise and proceeded with the purchase.
- After Timko died, his estate argued that no consideration supported the promise.
- The Michigan appellate court enforced the pledge under promissory estoppel, holding that the school's reliance made the promise binding despite the absence of consideration.

Practical Examples:

1. **Employee Pension Promise**
   - A company promises an employee a lifetime pension if they retire early.
   - The employee retires, giving up salary and benefits in reliance.
   - Later, the company refuses to pay.
   - A court may enforce the promise because the employee detrimentally relied on it.
2. **Landlord and Late Fees**
   - A landlord promises tenants that no late fees will be charged as long as rent is paid within a week.
   - Tenants rely on this and consistently pay on the 5th day of the month.
   - The landlord later tries to enforce late fees retroactively.
   - Courts may stop the landlord, enforcing the promise under promissory estoppel.
3. **Scholarship Reliance**
   - A university promises a student a full scholarship if they transfer schools.
   - The student withdraws from their old school and moves across the country.
   - When the university refuses to provide the scholarship, the student has a strong claim under promissory estoppel, since they relied to their detriment.
4. **Supplier Agreement**
   - A manufacturer promises a supplier a long-term contract, and the supplier invests in new equipment to meet demand.
   - The manufacturer then backs out.

- Courts may enforce the promise because the supplier reasonably relied by making significant expenditures.

Rationale:
Promissory estoppel reflects the principle that fairness sometimes outweighs technical rules. Even when consideration is missing, courts enforce promises when reliance has caused real harm and injustice would result from non-enforcement.

Charitable Subscription

Definition:
A **charitable subscription** is a promise to donate money or property to a charitable organization, such as a university, hospital, church, or nonprofit. Historically, these promises were difficult to enforce because they often lacked traditional consideration—there was no clear bargained-for exchange. Modern courts, however, increasingly uphold such pledges either on **public policy grounds** or under **reliance theories** like promissory estoppel.

When Enforceable:

1. **Reliance by the Charity (Promissory Estoppel)**
   - If the charity takes substantial action in reliance on the pledge—such as starting construction, hiring staff, or announcing programs—the donor's promise may be enforced.
   - Example: A donor pledges $50,000 for a hospital's new cancer wing. The hospital begins building in reliance on the pledge. The donor later refuses to pay. Courts typically enforce the promise.
2. **Public Policy Enforcement**
   - Some courts enforce charitable pledges outright, even without proof of reliance, reasoning that public policy strongly favors the stability and reliability of charitable giving.
   - Example: A donor pledges $1 million to a university endowment fund, with no conditions. Even without reliance, a court may enforce the pledge because charities depend on such commitments for long-term planning.
3. **Mutual-Promise Theory**
   - In a few jurisdictions, pledges made as part of a fundraising campaign are treated as supported by **mutual consideration**: each pledge is enforceable because it is supported by the promises of other donors.
   - Example: A donor pledges $10,000 as part of a community fundraising drive. Courts may enforce the pledge on the basis that the collective pledges form consideration for each other.

Additional Examples:

- **Named Recognition:** A university names its new library after a benefactor in reliance on the donor's pledge of $500,000. If the donor withdraws, courts often enforce payment, since the university relied by granting recognition and possibly soliciting further donations based on the promise.
- **Charity Programs:** A church announces a new food pantry program after receiving a donor's pledge of $25,000. If the donor fails to pay and the church has already expanded services, the pledge may be enforced under promissory estoppel.
- **Reliance vs. Non-Reliance Situations:**
  - Reliance: A hospital begins a $2 million project after a $250,000 pledge—enforceable.
  - Non-reliance but enforceable on policy: A pledge to donate $1,000 annually for five years to a nonprofit foundation—some courts will still enforce even if no specific reliance is shown.

Rationale:
Courts enforce charitable subscriptions because:

1. They protect organizations that reasonably rely on donations for major projects and services.
2. They encourage philanthropy and ensure accountability for public commitments.
3. They align with public policy goals of supporting charities, education, and community welfare.

Promises Enforceable under the UCC

The Uniform Commercial Code (UCC) expands enforceability of promises even without traditional consideration:

1. **Waiver or Renunciation (UCC §1-107):**
   - A party may waive rights or claims in writing without new consideration.
   - Example: A buyer waives a late-delivery claim in writing.
2. **Modification Without Consideration (UCC §2-209):**
   - Contract modifications are enforceable if made in **good faith**, even without new consideration.
   - Example: A seller agrees to earlier delivery without a price change.
3. **Firm Offers by Merchants (UCC §2-205):**
   - A merchant's written, signed promise to keep an offer open is binding without consideration (up to three months).
   - Example: A car dealer promises in writing to hold an offer open for 30 days.
4. **Reservation of Rights (UCC §1-207):**
   - A party may accept performance while reserving additional claims.
   - Example: A creditor cashes a "paid in full" check but writes "rights reserved." Depending on jurisdiction, they may still pursue the balance.

KEY TAKEAWAY

While the traditional rule requires consideration, courts and legislatures recognize **several exceptions**. Past consideration remains unenforceable, but obligations can be revived after the statute of limitations, promises may be enforced under promissory estoppel, charitable subscriptions are often binding, and the UCC allows for flexibility in modifications, waivers, and firm offers. These doctrines ensure fairness and adapt contract law to commercial realities and social needs.

EXERCISES

1. What theories are used to enforce charitable subscriptions?
2. What are the elements necessary for the application of the doctrine of promissory estoppel?
3. Promises unenforceable because barred by bankruptcy or by the running of the statute of limitations can be revived without further consideration. What do the two circumstances have in common?
4. Under the UCC, when is no consideration required where it would be in equivalent situations at common law?

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9.4: Cases

Consideration for an Option

Board of Control of Eastern Michigan University v. Burgess

206 N.W.2d 256 (Mich. 1973)

Burns, J.

On February 15, 1966, defendant signed a document which purported to grant to plaintiff a 60-day option to purchase defendant's home. That document, which was drafted by plaintiff's agent, acknowledged receipt by defendant of "One and no/100 ($1.00) Dollar and other valuable consideration." Plaintiff concedes that neither the one dollar nor any other consideration was ever paid or even tendered to defendant. On April 14, 1966, plaintiff delivered to defendant written notice of its intention to exercise the option. On the closing date defendant rejected plaintiff's tender of the purchase price. Thereupon, plaintiff commenced this action for specific performance.

At trial defendant claimed that the purported option was void for want of consideration, that any underlying offer by defendant had been revoked prior to acceptance by plaintiff, and that the agreed purchase price was the product of fraud and mutual mistake. The trial judge concluded that no fraud was involved, and that any mutual mistake was not material. He also held that defendant's acknowledgment of receipt of consideration bars any subsequent contention to the contrary. Accordingly, the trial judge entered judgment for plaintiff.

Options for the purchase of land, if based on valid consideration, are contracts which may be specifically enforced. [Citations] Conversely, that which purports to be an option, but which is not based on valid consideration, is not a contract and will not be enforced. [Citations] One dollar is valid consideration for an option to purchase land, provided the dollar is paid or at least tendered. [Citations] In the instant case defendant received no consideration for the purported option of February 15, 1966.

A written acknowledgment of receipt of consideration merely creates a rebuttable presumption that consideration has, in fact, passed. Neither the parol evidence rule nor the doctrine of estoppel bars the presentation of evidence to contradict any such acknowledgment. [Citation]

It is our opinion that the document signed by defendant on February 15, 1966, is not an enforceable option, and that defendant is not barred from so asserting.

The trial court premised its holding to the contrary on *Lawrence v. McCalmont*...(1844). That case is significantly distinguishable from the instant case. Mr. Justice Story held that '(t)he guarantor acknowledged the receipt of one dollar, and is now estopped to deny it.' However, in reliance upon the guaranty substantial credit had been extended to the guarantor's sons. The guarantor had received everything she bargained for, save one dollar. In the instant case defendant claims that she never received any of the consideration promised her.

That which purports to be an option for the purchase of land, but which is not based on valid consideration, is a simple offer to sell the same land. [Citation] An option is a contract collateral to an offer to sell whereby the offer is made irrevocable for a specified period. [Citation] Ordinarily, an offer is revocable at the will of the offeror. Accordingly, a failure of consideration affects only the collateral contract to keep the offer open, not the underlying offer.

A simple offer may be revoked for any reason or for no reason by the offeror at any time prior to its acceptance by the offeree. [Citation] Thus, the question in this case becomes, 'Did defendant effectively revoke her offer to sell before plaintiff accepted that offer?'...

Defendant testified that within hours of signing the purported option she telephoned plaintiff's agent and informed him that she would not abide by the option unless the purchase price was increased. Defendant also testified that when plaintiff's agent delivered to her on April 14, 1966, plaintiff's notice of its intention to exercise the purported option, she told him that 'the option was off'.

Plaintiff's agent testified that defendant did not communicate to him any dissatisfaction until sometime in July, 1966.

If defendant is telling the truth, she effectively revoked her offer several weeks before plaintiff accepted that offer, and no contract of sale was created. If plaintiff's agent is telling the truth, defendant's offer was still open when plaintiff accepted that offer, and an enforceable contract was created. The trial judge thought it unnecessary to resolve this particular dispute. In light of our holding the dispute must be resolved.

An appellate court cannot assess the credibility of witnesses. We have neither seen nor heard them testify. [Citation] Accordingly, we remand this case to the trial court for additional findings of fact based on the record already before the court....

Reversed and remanded for proceedings consistent with this opinion. Costs to defendant.

CASE QUESTIONS

1. Why did the lower court decide the option given by the defendant was valid?
2. Why did the appeals court find the option invalid?
3. The case was remanded. On retrial, how could the plaintiff (the university) still win?
4. It was not disputed that the defendant signed the purported option. Is it right that she should get out of it merely because she didn't really get the $1.00?

Consideration: Preexisting Obligation

Denney v. Reppert

432 S.W.2d 647 (Ky. 1968)

R. L. Myre, Sr., Special Commissioner.

The sole question presented in this case is which of several claimants is entitled to an award for information leading to the apprehension and conviction of certain bank robbers....

On June 12th or 13th, 1963, three armed men entered the First State Bank, Eubank, Kentucky, and with a display of arms and threats robbed the bank of over $30,000 [about $208,000 in 2010 dollars]. Later in the day they were apprehended by State Policemen Garret Godby, Johnny Simms and Tilford Reppert, placed under arrest, and the entire loot was recovered. Later all of the prisoners were convicted and Garret Godby, Johnny Simms and Tilford Reppert appeared as witnesses at the trial.

The First State Bank of Eubank was a member of the Kentucky Bankers Association which provided and advertised a reward of $500.00 for the arrest and conviction of each bank robber. Hence the outstanding reward for the three bank robbers was $1,500.00 [about $11,000 in 2010 dollars]. Many became claimants for the reward and the Kentucky State Bankers Association being unable to determine the merits of the claims for the reward asked the circuit court to determine the merits of the various claims and to adjudge who was entitled to receive the reward or share in it. All of the claimants were made defendants in the action.

At the time of the robbery the claimants Murrell Denney, Joyce Buis, Rebecca McCollum and Jewell Snyder were employees of the First State Bank of Eubank and came out of the grueling situation with great credit and glory. Each one of them deserves approbation and an accolade. They were vigilant in disclosing to the public and the peace officers the details of the crime, and in describing the culprits, and giving all the information that they possessed that would be useful in capturing the robbers. Undoubtedly, they performed a great service. It is in the evidence that the claimant Murrell Denney was conspicuous and energetic in his efforts to make known the robbery, to acquaint the officers as to the personal appearance of the criminals, and to give other pertinent facts.

The first question for determination is whether the employees of the robbed bank are eligible to receive or share in the reward. The great weight of authority answers in the negative. [Citation] states the rule thusly:

'To the general rule that, when a reward is offered to the general public for the performance of some specified act, such reward may be claimed by any person who performs such act, is the exception of agents, employees and public officials who are acting within the scope of their employment or official duties. * * *.'...

At the time of the robbery the claimants Murrell Denney, Joyce Buis, Rebecca McCollum, and Jewell Snyder were employees of the First State Bank of Eubank. They were under duty to protect and conserve the resources and moneys of the bank, and safeguard

every interest of the institution furnishing them employment. Each of these employees exhibited great courage, and cool bravery, in a time of stress and danger. The community and the county have recompensed them in commendation, admiration and high praise, and the world looks on them as heroes. But in making known the robbery and assisting in acquainting the public and the officers with details of the crime and with identification of the robbers, they performed a duty to the bank and the public, for which they cannot claim a reward.

The claims of Corbin Reynolds, Julia Reynolds, Alvie Reynolds and Gene Reynolds also must fail. According to their statements they gave valuable information to the arresting officers. However, they did not follow the procedure as set forth in the offer of reward in that they never filed a claim with the Kentucky Bankers Association. It is well established that a claimant of a reward must comply with the terms and conditions of the offer of reward. [Citation]

State Policemen Garret Godby, Johnny Simms and Tilford Reppert made the arrest of the bank robbers and captured the stolen money. All participated in the prosecution. At the time of the arrest, it was the duty of the state policemen to apprehend the criminals. Under the law they cannot claim or share in the reward and they are interposing no claim to it.

This leaves the defendant, Tilford Reppert the sole eligible claimant. The record shows that at the time of the arrest he was a deputy sheriff in Rockcastle County, but the arrest and recovery of the stolen money took place in Pulaski County. He was out of his jurisdiction, and was thus under no legal duty to make the arrest, and is thus eligible to claim and receive the reward. In [Citation] it was said:

'It is * * * well established that a public officer with the authority of the law to make an arrest may accept an offer of reward or compensation for acts or services performed outside of his bailiwick or not within the scope of his official duties. * * *.'...

It is manifest from the record that Tilford Reppert is the only claimant qualified and eligible to receive the reward. Therefore, it is the judgment of the circuit court that he is entitled to receive payment of the $1,500.00 reward now deposited with the Clerk of this Court.

The judgment is affirmed.

CASE QUESTIONS

1. Why did the Bankers Association put the resolution of this matter into the court's hands?
2. Several claimants came forward for the reward; only one person got it. What was the difference between the person who got the reward and those who did not?

Consideration: Required for Contract Modification

Gross v. Diehl Specialties International, Inc.

776 S.W.2d 879 (Missouri Ct. App. 1989)

Smith, J.

Plaintiff appeals from a jury verdict and resultant judgment for defendant in a breach of employment contract case....

Plaintiff was employed under a fifteen year employment contract originally executed in 1977 between plaintiff and defendant. Defendant, at that time called Dairy Specialties, Inc., was a company in the business of formulating ingredients to produce non-dairy products for use by customers allergic to cow's milk. Plaintiff successfully formulated [Vitamite]...for that usage.

Thereafter, on August 24, 1977, plaintiff and defendant corporation entered into an employment contract employing plaintiff as general manager of defendant for fifteen years. Compensation was established at $14,400 annually plus cost of living increases. In addition, when 10% of defendant's gross profits exceeded the annual salary, plaintiff would receive an additional amount of compensation equal to the difference between his compensation and 10% of the gross profits for such year. On top of that plaintiff was to receive a royalty for the use of each of his inventions and formulae of 1% of the selling price of all of the products produced by defendant using one or more of plaintiff's inventions or formulae during the term of the agreement. That amount was increased to 2% of the selling price following the term of the agreement. The contract further provided that during the term of the agreement the inventions and formulae would be owned equally by plaintiff and defendant and that following the term of the agreement the ownership would revert to plaintiff. During the term of the agreement defendant had exclusive rights to use of the

inventions and formulae and after the term of agreement a non-exclusive right of use.

At the time of the execution of the contract, sales had risen from virtually nothing in 1976 to $750,000 annually from sales of Vitamite and a chocolate flavored product formulated by plaintiff called Chocolite. [Dairy's owner] was in declining health and in 1982 desired to sell his company. At that time yearly sales were $7,500,000. [Owner] sold the company to the Diehl family enterprises for 3 million dollars.

Prior to sale Diehl insisted that a new contract between plaintiff and defendant be executed or Diehl would substantially reduce the amount to be paid for [the company]. A new contract was executed August 24, 1982. It reduced the expressed term of the contract to 10 years, which provided the same expiration date as the prior contract. It maintained the same base salary of $14,400 effective September 1982, thereby eliminating any cost of living increases incurred since the original contract. The 10% of gross profit provision remained the same. The new contract provided that plaintiff's inventions and formula were exclusively owned by defendant during the term of the contract and after its termination. The 1% royalty during the term of the agreement remained the same, but no royalties were provided for after the term of the agreement. No other changes were made in the agreement. Plaintiff received no compensation for executing the new contract. He was not a party to the sale of the company by [Owner] and received nothing tangible from that sale.

After the sale plaintiff was given the title and responsibilities of president of defendant with additional duties but no additional compensation. In 1983 and 1984 the business of the company declined severely and in October 1984, plaintiff's employment with defendant was terminated by defendant. This suit followed....

We turn now to the court's holding that the 1982 agreement was the operative contract. Plaintiff contends this holding is erroneous because there existed no consideration for the 1982 agreement. We agree. A modification of a contract constitutes the making of a new contract and such new contract must be supported by consideration. [Citation] Where a contract has not been fully performed at the time of the new agreement, the substitution of a new provision, resulting in a modification of the obligations on *both* sides, for a provision in the old contract still unperformed is sufficient consideration for the new contract. While consideration may consist of either a detriment to the promisee or a benefit to the promisor, a promise to carry out an already existing contractual duty does not constitute consideration. [Citation]

Under the 1982 contract defendant assumed no detriment it did not already have. The term of the contract expired on the same date under both contracts. Defendant undertook no greater obligations than it already had. Plaintiff on the other hand received less than he had under the original contract. His base pay was reduced back to its amount in 1977 despite the provision in the 1977 contract for cost of living adjustments. He lost his equal ownership in his formulae during the term of the agreement and his exclusive ownership after the termination of the agreement. He lost all royalties after termination of the agreement and the right to use and license the formulae subject to defendant's right to non-exclusive use upon payment of royalties. In exchange for nothing, defendant acquired exclusive ownership of the formulae during and after the agreement, eliminated royalties after the agreement terminated, turned its non-exclusive use after termination into exclusive use and control, and achieved a reduction in plaintiff's base salary. Defendant did no more than promise to carry out an already existing contractual duty. There was no consideration for the 1982 agreement.

Defendant asserts that consideration flowed to plaintiff because the purchase of defendant by the Diehls might not have occurred without the agreement and the purchase provided plaintiff with continued employment and a financially viable employer. There is no evidence to support this contention. Plaintiff had continued employment with the same employer under the 1977 agreement. Nothing in the 1982 agreement provided for any additional financial protection to plaintiff. The essence of defendant's position is that [the owner] received more from his sale of the company because of the new agreement than he would have without it. We have difficulty converting [the owner's] windfall into a benefit to plaintiff.

[Remanded to determine how much plaintiff should receive.]

CASE QUESTIONS

1. Why did the court determine that Plaintiff's postemployment benefits should revert to those in his original contract instead being limited to those in the modified contract?
2. What argument did Defendant make as to why the terms of the modified contract should be valid?

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9.5: Summary and Exercises

Summary

Most agreements—including contract modification at common law (but not under the Uniform Commercial Code [UCC])—are not binding contracts in the absence of what the law terms "consideration." Consideration is usually defined as a "legal detriment"—an act, forbearance, or a promise. The act can be the payment of money, the delivery of a service, or the transfer of title to property. Consideration is a legal concept in that it centers on the giving up of a legal right or benefit.

An understanding of consideration is important in many commonplace situations, including those in which (1) a debtor and a creditor enter into an accord that is later disputed, (2) a duty is preexisting, (3) a promise is illusory, and (4) creditors agree to a composition.

Some promises are enforceable without consideration. These include certain promises under the UCC and other circumstances, including (1) contracts barred by the statute of limitations, (2) promises by a bankrupt to repay debts, and (3) situations in which justice will be served by invoking the doctrine of promissory estoppel. Determining whether an agreement should be upheld despite the lack of consideration, technically defined, calls for a diligent assessment of the factual circumstances.

EXERCISES

1. Hornbuckle purchased equipment from Continental Gin (CG) for $6,300. However, after some of the equipment proved defective, Hornbuckle sent CG a check for $4,000 marked "by endorsement this check is accepted in full payment," and CG endorsed and deposited the check. May CG force Hornbuckle to pay the remaining $2,300? Why?
2. Joseph Hoffman alleged that Red Owl Stores promised him that it would build a store building in Chilton, Wisconsin, and stock it with merchandise for Hoffman to operate in return for Hoffman's investment of $18,000. The size, cost, design, and layout of the store building was not discussed, nor were the terms of the lease as to rent, maintenance, and purchase options. Nevertheless, in reliance on Red Owl's promise, the Hoffmans sold their bakery and grocery store business, purchased the building site in Chilton, and rented a residence there for the family. The deal was never consummated: a dispute arose, Red Owl did not build the store, and it denied liability to Hoffman on the basis that its promise to him was too indefinite with respect to all details for a contract to have resulted. Is Hoffman entitled to some relief? On what theory?
3. Raquel contracted to deliver one hundred widgets to Sam on December 15, for which he would pay $4,000. On November 25, Sam called her and asked if she could deliver the widgets on December 5. Raquel said she could, and she promised delivery on that day. Is her promise binding? Why?
4. Richard promised to have Darlene's deck awning constructed by July 10. On June 20, Darlene called him and asked if he could get the job done by July 3, in time for Independence Day. Richard said he could, but he failed to do so, and Darlene had to rent two canopies at some expense. Darlene claims that because Richard breached his promise, he is liable for the cost of awning rental. Is she correct—was his promise binding? Why?
5. Seller agreed to deliver gasoline to Buyer at $3.15 per gallon over a period of one year. By the sixth month, gasoline had increased in price over a dollar a gallon. Although Seller had gasoline available for sale, he told Buyer the price would have to increase by that much or he would be unable to deliver. Buyer agreed to the increase, but when billed, refused to pay the additional amount. Is Buyer bound by the promise? Explain.
6. Montbanks's son, Charles, was seeking an account executive position with Dobbs, Smith & Fogarty, Inc., a large brokerage firm. Charles was independent and wished no interference by his well-known father. The firm, after several weeks' deliberation, decided to hire Charles. They made him an offer on April 12, 2010, and Charles accepted. Montbanks, unaware that his son had been hired and concerned that he might not be, mailed a letter to Dobbs on April 13 in which he promised to give the brokerage firm $150,000 in commission business if the firm would hire his son. The letter was received by Dobbs, and the firm wishes to enforce it against Montbanks. May Dobbs enforce the promise? Why?
7. In 1869, William E. Story promised his nephew, William E. Story II (then sixteen years old), $5,000 (about $120,000 in today's money) if "Willie" would abstain from drinking alcohol, smoking, swearing, and playing cards or billiards for money until the nephew reached twenty-one years of age. All of these were legally permissible activities for the teenager at that time in New York State. Willie accepted his uncle's promise and did refrain from the prohibited acts until he turned twenty-one. When the young man asked for the money, his uncle wrote to him that he would honor the promise but would rather wait until Willie was older before delivering the money, interest added on. Willie agreed. Subsequently, Willie assigned the right to receive the money to one Hamer (Willie wanted the money sooner), and Story I died without making any payment. The estate,

administered by Franklin Sidway, refused to pay, asserting there was no binding contract due to lack of consideration: the boy suffered no "detriment," and the uncle got no benefit. The trial court agreed with the estate, and the plaintiff appealed. Should the court on appeal affirm or reverse? Explain.

8. Harold Pearsall and Joe Alexander were friends for over twenty-five years. About twice a week, they bought what they called a package: a half-pint of vodka, orange juice, two cups, and two lottery tickets. They went to Alexander's house to watch TV, drink screwdrivers, and scratch the lottery tickets. The two had been sharing tickets and screwdrivers since the Washington, DC, lottery began. On the evening in issue, Pearsall bought the package and asked Alexander, "Are you in on it?" Alexander said yes. Pearsall asked for his half of the purchase price, but Alexander had no money. A few hours later, Alexander, having come by some funds of his own, bought another package. He handed one ticket to Pearsall, and they both scratched the tickets; Alexander's was a $20,000 winner. When Pearsall asked for his share, Alexander refused to give him anything. Are the necessary elements of offer, acceptance, and consideration present here so as to support Pearsall's assertion the parties had a contract?
9. Defendant, Lee Taylor, had assaulted his wife, who took refuge in the house of Plaintiff, Harrington. The next day, Taylor gained access to the house and began another assault upon his wife. Mrs. Taylor knocked him down with an axe and was on the point of cutting his head open or decapitating him while he was lying on the floor when Plaintiff intervened and caught the axe as it was descending. The blow intended for Defendant fell upon Harrington's hand, mutilating it badly, but saving Defendant's life. Subsequently, Defendant orally promised to pay Plaintiff her damages but, after paying a small sum, failed to pay anything more. Is Harrington entitled to enforce Taylor's entire promise?
10. White Sands Forest Products (Defendant) purchased logging equipment from Clark Corporation (Plaintiff) under an installment contract that gave Plaintiff the right to repossess and resell the equipment if Defendant defaulted on the contract. Defendant did default and agreed to deliver the equipment to Plaintiff if Plaintiff would then discharge Defendant from further obligation. Plaintiff accepted delivery and resold the equipment, but the sale left a deficiency (there was still money owing by Defendant). Plaintiff then sued for the deficiency, and Defendant set up as a defense the accord and satisfaction. Is the defense good?

SELF-TEST QUESTIONS

1. Consideration
    1. can consist of a written acknowledgment of some benefit received, even if in fact the benefit is not delivered
    2. cannot be nominal in amount
    3. is a bargained-for act, forbearance, or promise from the promisee
    4. is all of the above
2. An example of valid consideration is a promise
    1. by a seventeen-year-old to refrain from drinking alcohol
    2. to refrain from going to court
    3. to cook dinner if the promisor can get around to it
    4. to repay a friend for the four years of free legal advice he had provided
3. An unliquidated debt is a debt
    1. one is not able to pay
    2. not yet paid
    3. of uncertain amount
    4. that is unenforceable debt
4. The rule that if one party to a contract has not made a binding obligation, the other party is not bound is called
    1. revocation
    2. mutuality of obligation
    3. accord and satisfaction
    4. estoppel
5. Examples of promises enforceable without consideration include
    1. an agreement modifying a sales contract
    2. a promise to pay a debt after the statute of limitations has run
    3. a debtor's promise to repay a debt that has been discharged in bankruptcy
    4. all of the above

SELF-TEST AnswerS

1. c
2. b

3. c
4. b
5. d

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10: DEFENSES TO CONTRACT FORMATION

Learning Objectives

After reading this chapter, you should understand the following:

- Contracts require “a meeting of the minds” between competent parties, and if there is no such “meeting,” the agreement is usually voidable.
- Parties must enter the contract voluntarily, without duress or undue influence.
- Misrepresentation or fraud, when proven, vitiates a contract.
- A mistake may make a contract voidable.
- Parties to a contract must have capacity—that is, not labor under infancy, intoxication, or insanity.

We turn to the second of the four requirements for a valid contract. In addition to manifestation of assent, a party’s assent must be real; he or she must consent to the contract freely, with adequate knowledge, and must have capacity. The requirement of real assent raises the following major questions:

1. Did the parties enter into the contract of their own free will, or was one forced to agree under duress or undue influence?
2. Did the parties enter into the contract with full knowledge of the facts, or was one or both led to the agreement through fraud or mistake?
3. Did both parties have the capacity to make a contract?

10.1: Duress and Undue Influence

10.2: Misrepresentation

10.3: Mistake

10.4: Capacity

10.5: Cases

10.6: Summary and Exercises

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10.1: Duress and Undue Influence

LEARNING OBJECTIVES

1. Recognize that if a person makes an agreement under duress (being forced to enter a contract against his or her will), the agreement is void.
2. Understand what undue influence is and what the typical circumstances are when it arises to make a contract voidable.

Duress

When a person is forced to do something against his or her will, that person is said to have been the victim of **duress**—compulsion. There are two types of duress: physical duress and duress by improper threat. A contract induced by physical violence is void.

Physical Duress

Physical duress occurs when a person is forced to enter into a contract because of the threat—or actual use—of physical harm. In other words, the person doesn't truly agree to the contract; instead, their actions are compelled by fear for their safety.

The **Restatement (Second) of Contracts, Section 174** explains:

> If conduct that appears to be a manifestation of assent by a party who does not intend to engage in that conduct is physically compelled by duress, the conduct is not effective as a manifestation of assent.

This means that if someone only "appears" to agree because they were forced, that agreement is not legally valid. Comment (a) to Section 174 further clarifies that when actual physical force is used, the person is essentially treated as a "mechanical instrument." Since they never intended to agree, there is **no contract at all**. Lawyers call this a *void contract* (as opposed to a *voidable* one).

Although the Restatement points out that physical duress is rare, it does happen. When it does, the contract is invalid, and the person applying the force may also be guilty of a crime, such as extortion or assault.

Example:

Imagine that Tony threatens to break Chris's arm unless Chris signs a contract selling his car for $1. Under physical duress, Chris signs the document. Since Chris's "agreement" was forced by the threat of bodily harm, the contract is **void**—it has no legal effect. Chris is not bound by the terms, and Tony could face criminal charges.

Duress by Threat

The second type of duress is **duress by threat**, which is far more common than physical duress. In this situation, one party threatens the other, leaving the victim feeling like they have no reasonable alternative but to agree to the contract. Unlike physical duress (which makes a contract *void*), duress by threat makes a contract **voidable**—the victim can choose to cancel it.

To decide whether duress by threat exists, several elements must be present:

1. **The threat must be improper.**
   - Not every threat counts as duress. For example, threatening to sue someone for a legitimate reason is usually not improper. But threatening to commit a crime or misuse legal rights (like blackmail) is improper.
2. **There must be no reasonable alternative.**
   - If the victim has another option (such as buying goods from a different supplier or pursuing legal remedies), the threat might not qualify as duress.

3. **The test is subjective.**
    - The question isn't whether a "reasonable person" would feel threatened—it's whether the specific victim actually felt pressured and gave in. Courts look at things like the victim's belief in the threatener's ability to follow through and how quickly the victim agreed after the threat.

Types of Improper Threats

- Threats of bodily harm or destruction of property
- Threats to start criminal prosecution (in bad faith)
- Threats to bring civil lawsuits made in bad faith
- Threats to breach the duty of good faith in an existing contract
- Threats to reveal embarrassing personal information

Examples

Example 1: Threat of Violence
Jack buys a car from Mr. Olson, a used-car dealer. The next day, Jack realizes the car is a lemon. He threatens to smash the windows of Olson's showroom unless Olson agrees to buy the car back for the full price. Olson, frightened and feeling he has no alternative, agrees. The repurchase contract is **voidable** because Olson only consented under an improper threat.

Example 2: Blackmail
Suppose Jack also knows that Olson has been tampering with odometers (a federal crime). Jack threatens to report Olson unless Olson repurchases the car. Even though Olson may be guilty, this misuse of the threat of prosecution makes the new contract voidable.

Example 3: Legitimate vs. Improper Lawsuit Threats
If Jack tells Olson, "I'm going to sue you to get my money back," this is not duress—he has a legal right to do so. But if Jack threatens to file a false lawsuit claiming fabricated damages, that would be an **improper threat** and could make Olson's agreement voidable.

Example 4: Threat to Breach a Contract
Olson agreed as part of the sale to cover repairs for 90 days. When the transmission fails after one month, Jack demands a replacement. Olson refuses unless Jack signs a new contract promising to buy his next car from him. If Jack has no funds and needs his car immediately, Olson's threat could be improper, making the contract voidable. But if replacement transmissions are widely available and affordable, Olson's demand may not amount to duress.

On the other hand, if unanticipated circumstances arise—say, Olson learns the replacement transmission costs three times more than expected—his refusal might be reasonable. In such a case, asking Jack to share the cost could be considered fair rather than improper.

Undue Influence

The **Restatement (Second) of Contracts, Section 177** defines undue influence as *"unfair persuasion."* It is considered a **milder form of duress**—not as extreme as threats or physical harm—but still powerful enough to make a contract voidable.

Undue influence occurs when someone improperly uses trust, power, or authority to persuade another person in a way that overcomes their free will. The victim may not realize they are being pressured because the persuasion happens in the context of a **special relationship of trust**.

Key Features of Undue Influence

- **Domination or Trust:** The victim is under the domination of the persuader or is justified in believing the persuader will not act in their best interest if they refuse.
- **Isolation:** The victim is often cut off from independent advice or guidance.
- **Substitution of Will:** The persuader's goals replace the victim's free choice.
- **Voidable Contract:** If undue influence is proven, the victim can void (cancel) the contract.

Common Situations

- A child pressuring an elderly or infirm parent into signing over property.
- A doctor persuading a vulnerable patient into an unfair financial agreement.
- A lawyer taking advantage of a client who does not understand the law.

What Courts Consider

Whether undue influence exists is a **question of fact**. Courts look at factors such as:

- The fairness (or unfairness) of the deal.
- Whether the victim had access to independent advice.
- The susceptibility of the victim (age, illness, lack of knowledge, or dependence).

Example

Sarah is 85 years old and relies heavily on her son, Tom, for daily care. Tom persuades Sarah to sign over her house to him, telling her it's "for her own good" and discouraging her from speaking to her lawyer or friends about the decision.

Here, Tom has isolated Sarah and used their relationship of trust to substitute his own objectives for hers. This would likely be considered **undue influence**, making the contract **voidable** at Sarah's option.

KEY TAKEAWAY

A contract induced by physical duress—threat of bodily harm—is void; a contract induced by improper threats—another type of duress—is voidable. Voidable also are contracts induced by undue influence, where a weak will is overborne by a stronger one.

EXERCISES

1. What are the two types of duress?
2. What are the elements necessary to support a claim of undue influence?

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10.2: Misrepresentation

LEARNING OBJECTIVES

After reading this section, you should be able to:

1. **Explain** the elements of fraudulent misrepresentation and how they differ from innocent and negligent misrepresentation.
2. **Identify** situations where statements of opinion, silence, or carelessness may amount to misrepresentation.
3. **Analyze** the legal consequences of misrepresentation, including when a contract is voidable and what remedies are available

Misrepresentation and Fraud

Contracts are built on the foundation of honesty and trust. When one party intentionally misleads another in order to induce them to enter into a contract, the law recognizes this as **fraud** (also called fraudulent misrepresentation). Fraud undermines the validity of the agreement because the victim's consent was obtained through deception rather than free and informed choice.

Scenario Introduction

Imagine that Ralph is selling his car and offers it to Jack. Ralph tells Jack that the car has "only 40,000 miles" on it. Unbeknownst to Jack, Ralph has **rolled back the mileage** on the odometer to make the car appear more valuable. Jack relies on this statement and agrees to purchase the car. Later, Jack discovers that the car has actually been driven 120,000 miles, and its true value is much lower.

This scenario illustrates the core issue of fraud in contracts: when one party knowingly makes a false statement of material fact, intending the other to rely on it, and the other party does in fact rely to their detriment.

Elements of Fraud

To establish fraud, the plaintiff must prove:

1. **Misrepresentation of a Material Fact**
   - The defendant made a false statement of fact (not opinion, not puffery).
   - Example: Ralph falsely stated the car had 40,000 miles.
2. **Knowledge of Falsity (Scienter)**
   - The defendant knew the statement was false or acted with reckless disregard for the truth.
   - Example: Ralph deliberately rolled back the odometer.
3. **Intent to Induce Reliance**
   - The defendant made the misrepresentation intending the other party to rely on it in making a decision.
   - Example: Ralph wanted Jack to rely on the mileage figure so he would agree to buy the car.
4. **Justifiable Reliance**
   - The plaintiff actually relied on the misrepresentation in entering into the contract.
   - That reliance must also be reasonable (justifiable) under the circumstances.

   In our scenario: Jack was justified in relying on Ralph's statement about the odometer. The mileage of a car is not something a buyer can reasonably determine on their own without professional inspection. While Jack could have taken the car to a mechanic, courts recognize that such reliance is generally reasonable without doing so—buyers are entitled to take a seller's mileage representation at face value.

   Counterexample: Suppose Ralph instead told Jack, "These tires are brand new." If Jack could clearly see that the tires were worn and bald, his reliance would not be justifiable. Courts do not protect blind reliance where the falsity is obvious or could have been discovered by simple observation.

5. **Damages**

- The plaintiff must have suffered actual harm as a result of the misrepresentation.
- Example: Jack overpaid for the car, which was worth far less than represented.

Negligent Misrepresentation

Not all misrepresentation is deliberate. Sometimes, a seller carelessly makes a false statement that induces reliance.

Suppose Ralph never rolled back the odometer but simply glanced at a service record, misread it, and told Jack the car had 40,000 miles when it actually had 120,000. Ralph did not intend to deceive Jack, but his careless statement was false.

In this case, Ralph may be liable for **negligent misrepresentation**. The elements are similar, but instead of proving intent to deceive, Jack must prove that Ralph:

1. Made a false statement of material fact.
2. Failed to exercise reasonable care in verifying the truth of the statement.
3. Intended or expected Jack to rely on it.
4. Jack reasonably relied on it.
5. Jack suffered damages as a result.

Here, Jack's reliance would still be justifiable because mileage is not something he could confirm without professional help. Ralph, as the seller, was in the better position to verify the truth before speaking.

Statements of Opinion

Not every false or misleading statement qualifies as misrepresentation. The law generally distinguishes between **statements of fact** (which can support misrepresentation claims) and **statements of opinion** (which usually cannot).

- **Fact:** Something objectively verifiable, like mileage, year of manufacture, or accident history.
- **Opinion:** A subjective belief, judgment, or "sales talk" that reasonable buyers are expected to take with caution.

Example 1 – Mere Opinion (Not Misrepresentation):
Ralph tells Jack, "This is the best car on the market—you won't find a better one in town." This is sales puffery, not a factual claim. Jack cannot sue if the car later turns out to be average.

Example 2 – Opinion by an Expert (May Count as Misrepresentation):
If Ralph is a licensed mechanic and tells Jack, "In my professional opinion, the engine is in excellent condition and will last for at least 100,000 more miles," but Ralph knows the engine is failing, this crosses into fraudulent misrepresentation. Courts may hold experts or professionals accountable for misleading opinions because buyers justifiably rely on their superior knowledge.

Example 3 – Mixed Statement:
Ralph says, "This car feels like new." If Jack can see worn seats, scratches, and old tires, this is likely puffery. But if Ralph couples the opinion with false facts—"It only has 40,000 miles, so of course it feels like new"—then the statement may be actionable.

Puffery

Puffery is a special category of statements that the law treats as **non-actionable exaggeration or sales talk**. Puffery includes vague, subjective, or promotional claims that no reasonable person would take literally.

- Puffery does **not** create liability because courts expect consumers to recognize exaggerations.
- Puffery contrasts with factual misrepresentation, which involves specific, verifiable falsehoods.

Examples of Puffery (Not Misrepresentation):

- Ralph tells Jack, "This car is a dream ride—you'll look amazing driving it."
- A restaurant claims, "We have the world's best coffee."
- A tech company advertises its laptop as "lightning fast," even if it's slower than a competitor's.

Not Puffery (Actionable Misrepresentation):

- Ralph says, “This car has never been in an accident,” when in fact it has.
- A restaurant claims, “We have 100% organic ingredients,” but uses conventional produce.
- A laptop manufacturer states, “Battery lasts 12 hours,” when it lasts only 3.

Courts draw the line between puffery and misrepresentation by asking: *Would a reasonable person treat this statement as a factual claim, or as harmless sales exaggeration?*

Misrepresentation by Silence (Concealment)

Sometimes, fraud does not require an outright false statement—**silence or concealment** can amount to misrepresentation when one party has a duty to speak. While the general rule is that parties to a contract are not required to volunteer information, the law imposes a duty to disclose in certain circumstances.

General Rule

Silence alone is usually not misrepresentation. Buyers and sellers are often expected to use caution and diligence, and “caveat emptor” (let the buyer beware) applies. However, when nondisclosure amounts to **active concealment** or when fairness demands disclosure, courts may treat silence as fraudulent misrepresentation.

When Silence Becomes Actionable

1. **Duty to Disclose Material Facts** – If a party knows a fact that materially affects the value or desirability of the contract and the other party cannot reasonably discover it, failure to disclose may be fraudulent.
2. **Partial Disclosure** – If a party makes a statement that is only half true, omitting critical information, silence can turn the statement into a misrepresentation.
3. **Special Relationships** – Fiduciary or trust-based relationships (attorney-client, guardian-ward, business partners) impose heightened duties to disclose.
4. **Active Concealment** – Taking steps to hide defects (painting over water damage, rolling back an odometer) amounts to misrepresentation even without words.

Example – Ralph and Jack (Concealment)

Ralph is selling his car to Jack. Ralph doesn’t say anything about the fact that the car was previously flooded in a hurricane, causing hidden engine damage. Jack cannot easily discover this without an inspection. Ralph’s silence amounts to **misrepresentation by concealment** because he knew about the damage, knew it was material, and failed to disclose it.

Counterexample – Tires Scenario

If Ralph stays silent about the condition of the car’s tires, Jack cannot later claim concealment because the condition of the tires is obvious and discoverable upon reasonable inspection. Jack is not justified in relying on Ralph’s silence about something he could see for himself.

Case Illustration – *Obde v. Schlemeyer* (Wash. 1960)

In this case, sellers failed to disclose a termite infestation to buyers. The court held that the sellers’ silence was fraudulent because they knew about the problem and the buyers had no reasonable way to discover it themselves before purchase.

Defenses to Misrepresentation and Fraud

Defendants accused of misrepresentation or fraud may raise several defenses to avoid liability. These defenses focus on showing that one or more of the required elements (false statement, scienter, intent, reliance, damages) are missing.

1. **No Misrepresentation of Fact**
   - The statement was not about a material fact but mere opinion or puffery.
   - Example: Ralph says, "This car is a beauty—you'll love driving it." Jack cannot claim fraud because no factual assertion was made.
2. **Truth or Substantial Truth**
   - If the defendant's statement was accurate—or close enough to not materially mislead—the defense of truth applies.
   - Example: Ralph claims the car has "about 40,000 miles," and it has 41,200. Courts may find this substantially true, not fraudulent.
3. **No Justifiable Reliance**
   - The plaintiff's reliance was unreasonable under the circumstances.
   - Example: Ralph says, "The tires are brand new," but Jack can plainly see they are worn. Jack cannot reasonably rely on that statement.
4. **Lack of Scienter (Good Faith Mistake)**
   - For fraud, the defendant must know the statement is false or act with reckless disregard for the truth. If the misstatement was a genuine, reasonable mistake, the claim may fail (though negligent misrepresentation might still apply).
5. **No Causation or No Damages**
   - Even if there was misrepresentation, the plaintiff must show actual harm. If the false statement had no impact on the decision or caused no measurable loss, damages cannot be recovered.

Remedies for Misrepresentation and Fraud

When misrepresentation or fraud is proven, courts may award a combination of **contract remedies** (focused on undoing the unfair deal) and **tort remedies** (focused on compensating for losses).

1. **Rescission (Contract Remedy)**
   - The contract may be **canceled** (rescinded), restoring both parties to their pre-contract positions.
   - Example: Jack returns the car and Ralph returns the purchase price.
2. **Restitution**
   - Along with rescission, courts often order restitution to prevent unjust enrichment. Each party must give back what they received.
3. **Damages (Tort Remedy)**
   - The defrauded party may recover damages for actual losses suffered. Courts typically apply the **"benefit of the bargain" rule**, awarding the difference between the value as represented and the actual value.
   - Example: If Ralph sold the car for $10,000 claiming it had 40,000 miles, but the car with 120,000 miles was worth only $5,000, Jack can recover $5,000 in damages.
4. **Punitive Damages**
   - In cases of intentional fraud (not negligent misrepresentation), courts may award punitive damages to punish willful misconduct and deter future fraud.
   - Example: If Ralph ran a pattern of rolling back odometers and deceiving multiple buyers, punitive damages may be imposed.
5. **Reformation**
   - In some cases, instead of canceling the contract, the court may reform (rewrite) the contract to reflect the truth or the parties' actual intent.
   - Example: If Ralph misrepresented the car's warranty terms, the court could reform the contract to accurately reflect the true warranty coverage.

KEY TAKEAWAY

Misrepresentation and fraud undermine the foundation of contracts by substituting deception for genuine agreement. Fraudulent misrepresentation requires proof of a false statement of material fact, knowledge of its falsity, intent to induce reliance, justifiable reliance, and damages. Negligent misrepresentation arises from careless but false statements. Not all statements—such as puffery or obvious opinions—are actionable, and silence can amount to misrepresentation only when there is a duty to disclose. Victims may seek rescission, restitution, damages, or even punitive damages, while defendants may argue that reliance was unjustified or no material harm occurred. Ultimately, the law balances protecting parties from deception with holding them responsible for reasonable diligence.

EXERCISES

1. Distinguish between fraudulent misrepresentation and nonfraudulent misrepresentation, between fraud in the execution and fraud in the inducement, and between negligent and innocent misrepresentation.
2. List the elements that must be shown to prove the four different types of misrepresentation noted in Exercise 1.
3. What is the difference between the traditional common-law approach to remedies for fraud and the UCC's approach?

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10.3: Mistake

LEARNING OBJECTIVES

1. Distinguish between fraudulent misrepresentation and mistake in contract law.
2. Explain the difference between unilateral mistake and mutual mistake.
3. Identify the three requirements for proving mutual mistake under the Restatement (Second) of Contracts §152.
4. Understand how courts allocate the risk of mistake between the parties.
5. Recognize the remedies available when a contract is affected by mistake (rescission, reformation, restitution, or adjustment).

Mistake in Contract Law

In discussing fraud, we have considered how trickery by one party can make a contract void or voidable. But sometimes, neither party is being dishonest. Instead, both or one party may be operating under a mistaken belief about an important fact, leading them to think they have agreed to something when they really have not. A mistake is defined by the *Restatement (Second) of Contracts, Section 151* as "a belief about a fact that is not in accord with the truth."

Scenario: The Art Dealer and the Painting

Consider this situation: A wealthy collector purchases what he believes to be an authentic Renaissance painting from a reputable art dealer for $2 million. Both the buyer and the dealer genuinely believe the artwork is original. Later, the buyer sells the painting to a third party, who proudly takes it to an international art show in Italy. Experts there discover that the painting is not authentic at all, but a skilled reproduction.

This discovery highlights a mistake—not fraud. Neither the dealer nor the original buyer intentionally misrepresented the painting. Instead, both shared the same mistaken belief about its authenticity. This kind of error raises the issue of whether the contract can or should be enforced when the underlying assumption is false.

Mistake by One Party: Unilateral Mistake

When only one party is mistaken about a material fact, it is known as a **unilateral mistake**.

General Rule:
Ordinarily, a contract is not voidable merely because one party made a mistake about the subject matter. For example, a buyer cannot avoid a contract simply because they later decide the truck they purchased isn't powerful enough, or the dress they bought doesn't fit.

Exceptions:
Relief may be granted when:

- The non-mistaken party knows or should have known about the other's mistake but seeks to take advantage of it.
- The mistake was caused by clerical or mathematical error that would make enforcement unconscionable.
- Drafting errors in written contracts may be corrected through **reformation**, so that the document matches the parties' true intent (*Sikora v. Vanderploeg, 212 S.W.3d 277 (Tenn. Ct. App. 2006)*).

Example:
A contractor forgets to include insulation costs in a bid. Normally, this negligence would not void the contract. But if enforcing the mistake would cause severe hardship, and the other party knew or should have known of the error, courts may allow correction.

Mistake by Both Parties: Mutual Mistake

When both parties are mistaken about a material fact at the time of contracting, the error may make the contract voidable.

Restatement (Second) of Contracts, Section 152 sets out three requirements:

1. **Basic Assumption** – The mistake relates to a fundamental assumption on which the contract was made.
   - *Sherwood v. Walker (1887)* – "The barren cow case." Both buyer and seller believed a cow was infertile. When discovered to be pregnant, the court ruled that fertility was a basic assumption.
2. **Material Effect** – The mistake must have a material effect on the agreed exchange.
   - In *Sherwood*, forcing the seller to perform would have meant giving up far more value than expected, and the buyer would have received a windfall.
3. **Risk Allocation** – The party seeking relief must not bear the risk of the mistake.
   - If a party contracts "with conscious ignorance"—knowing they don't know the truth but going ahead anyway—they bear the risk.

Allocating the Risk of Mistake

Courts carefully examine whether the party seeking relief assumed the risk of mistake. Risk may be allocated in three primary ways:

1. **By Agreement** – The contract itself may place the risk on one party.
   - Example: An "as is" clause in the sale of a house shifts the risk of undisclosed defects to the buyer. If the buyer later finds termites, they generally cannot void the contract because they assumed the risk.
2. **By Conscious Ignorance** – A party may bear the risk if they knew they didn't know an important fact but proceeded anyway.
   - Example: An antique dealer sells a painting for $100 without verifying its authenticity. If it later turns out to be a lost El Greco worth $1 million, the dealer cannot void the sale—they knowingly took the risk.
3. **By the Court** – Courts may allocate risk to the party best positioned to avoid it.
   - Example: In the art dealer scenario, if the buyer could have easily requested a certificate of authenticity but failed to do so, a court may find that the buyer bore the risk of mistake. Conversely, if the dealer, as a professional, was better positioned to verify authenticity, the risk may fall on them.

Applying These Rules to the Art Scenario

- If both the dealer and the buyer genuinely believed the Renaissance painting was authentic, this may be a **mutual mistake** because authenticity was a **basic assumption** of the contract. The fact that the painting was a reproduction significantly changes the value exchanged, satisfying the "material effect" requirement. Unless the buyer assumed the risk (e.g., by agreeing to buy it "as is" without authentication), the buyer may rescind the contract.
- If only the buyer was mistaken (say the dealer knew or suspected the painting was not authentic), the case would shift from "mistake" to **fraudulent misrepresentation**, because the dealer had knowledge.

Remedies for Mistake

When a contract is affected by unilateral or mutual mistake, courts may provide several remedies:

1. **Rescission (Cancellation)**
   - The most common remedy. The contract is set aside, and the parties are returned to their pre-contract positions.
   - Example: In the art scenario, the original buyer could seek rescission against the dealer once the painting is revealed to be a forgery.
2. **Reformation (Correction of the Contract)**
   - Available when the mistake is in the written expression of the agreement (e.g., drafting or clerical errors). The court reforms the document to reflect the true intent of the parties.
   - Example: A contract mistakenly lists delivery of "100 chairs" when both parties agreed on "10 chairs." A court may correct it.
3. **Restitution**
   - Ensures that any benefits conferred under the mistaken contract are returned to prevent unjust enrichment.
   - Example: If Jack paid Ralph $2 million for the fake painting, restitution would require Ralph to refund the money.
4. **Partial Enforcement or Adjustment**
   - In some cases, courts may enforce the contract with adjusted terms to reflect the reality of the situation.
   - Example: If a mutual mistake involved a minor error in quantity or price, the court might adjust the terms instead of voiding the entire contract.

KEY TAKEAWAY

Mistake differs from fraud because there is no intentional deception. A unilateral mistake rarely voids a contract unless the other party knew of the error or enforcement would be unconscionable. A mutual mistake can make a contract voidable if it involves a basic assumption, materially alters the exchange, and the party seeking relief did not assume the risk. Courts may provide remedies—rescission, reformation, restitution, or adjusted enforcement—to restore fairness when faulty assumptions mislead one or both parties.

EXERCISES

1. Why is relief usually not granted for unilateral mistakes? When is relief granted for them?
2. If there is a mutual mistake, what does the party seeking relief have to show to avoid the contract?

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10.4: Capacity

LEARNING OBJECTIVES

1. Understand that infants may avoid their contracts, with limitations.
2. Understand that insane or intoxicated people may avoid their contracts, with limitations.
3. Understand the extent to which contracts made by mentally ill persons are voidable, void, or effectively enforceable.
4. Recognize that contracts made by intoxicated persons may be voidable.

Capacity to Contract

A contract is a meeting of minds. If someone lacks the mental capacity to understand what he is assenting to—or that he is assenting to anything—it is unreasonable to hold him to the consequences of his act. At common law there are various classes of people who are presumed to lack the requisite capacity. These include minors (infants), the mentally ill, and the intoxicated.

In this chapter we will see the terms **void** and **voidable** used frequently:

1. A **void** contract is one that never had legal effect. No rights or obligations are created, and neither party can enforce it.
2. A **voidable** contract is one that is valid and enforceable unless and until the protected party chooses to disaffirm. The protected party may avoid the contract, but the other party cannot.

Minors (Infants)

The General Rule

In most states, a minor (or infant) is a person younger than 18 years old. Minors may avoid (disaffirm) their contracts either while still underage or within a reasonable time after reaching majority. The law presumes minors lack the maturity and judgment of adults, so it protects them from being bound by agreements that may not be in their best interest.

Minors vs. Infants

The words minor and infant are often used interchangeably, but they don't always mean exactly the same thing:

1. Infant: a person under 18.
2. Minor: a person who has not yet reached the full legal age of majority for all purposes (which may include restrictions above 18, such as drinking at 21).

Age of Majority

- In the 1970s, most states lowered the age of majority from 21 to 18 or 19, following the Twenty-Sixth Amendment, which gave 18-year-olds the right to vote.
- Today, most states recognize 18 as the age of contractual majority.
- Mississippi remains the exception, with 21 as the age of majority.

Voidable, Not Void

A minor's contract is **voidable, not void**. This means:

1. The minor can disaffirm the contract.
2. The adult cannot enforce it against the minor.
3. The minor may enforce it against the adult if they choose.

Necessities

Minors are generally liable for the reasonable value of necessities—food, clothing, shelter, medicine, and sometimes goods or services that allow them to earn a living.

Nonvoidable Contracts

Certain contracts cannot be disaffirmed by minors under state statutes, including:

1. Insurance contracts
2. Medical care or education agreements
3. Bank accounts and securities
4. Bonding contracts

Third-Party Rights

A minor loses the power to disaffirm if the rights of an innocent third party have intervened.

Misrepresentation of Age

- General rule: Even if a minor lies about their age, many states still allow disaffirmance.
- Trend: More courts deny disaffirmance where the minor affirmatively misrepresented age.
- Some states impose tort liability for fraudulent misrepresentation of age.

Ratification

When reaching majority, the individual must choose to either:

1. Ratify the contract (by words, conduct, or silence while continuing performance), or
2. Disaffirm it within a reasonable time.

Duty to Return Consideration

- Traditionally, a minor need only return what remains of the goods or consideration.
- Modern approach: Some courts require payment for depreciation or damage if the contract was fair (Dodson v. Shrader, 1992).

Torts Connected with Contracts

Minors are generally liable for torts (assault, negligence, trespass). But if the tort claim is merely a disguised attempt to enforce a contract, it is barred.

Persons Who Are Mentally Ill

Adjudicated vs. Non-Adjudicated Incapacity

1. **Adjudicated incapacity:** If a court has declared a person incompetent and appointed a guardian, any contract made by the person is **void**.
2. **Non-adjudicated incapacity:** Without a court finding, the contract is **voidable** if the person lacked capacity at the time of contracting.

Legal Tests for Capacity

Under Restatement (Second) of Contracts §15, a contract is voidable if, at the time of contracting:

1. The person was unable to understand the nature and consequences of the transaction (cognitive test), or
2. The person was unable to act reasonably in relation to the transaction, and the other party knew or should have known of the condition (volitional test).

Timing

Capacity is judged at the time the contract was made. Contracts made during lucid intervals are valid and enforceable.

Burden of Proof

The person seeking to avoid the contract must prove incapacity with evidence such as medical testimony, witnesses, or records.

Fairness to Good-Faith Counterparties

Courts consider whether the other party knew or should have known of the incapacity. If the contract was fair and the counterparty acted in good faith, rescission may be conditioned on restitution to prevent unjust enrichment.

Remedies

1. Rescission: The contract may be avoided, provided consideration is returned if possible.
2. Reformation: Courts may reform contracts made during lucid intervals to reflect actual intent.
3. Restitution: Courts often require return of benefits to prevent unjust enrichment.
4. Necessaries: Even if a contract is void or voidable, the person is liable for the reasonable value of necessities like housing, food, or medical care.

Ratification

A person who regains capacity may ratify the contract by continuing performance or affirming it after recovery.

Intoxicated Persons

General Rule

A contract made while intoxicated is **voidable** if the person was so impaired they could not understand the nature and consequences of the transaction, and the other party knew or should have known of the impairment.

Enforceability

- If the intoxicated person was aware of their actions, the contract is binding.
- If the other party was unaware of the intoxication, and the contract appeared fair, courts may enforce it.

Ratification

An intoxicated person may ratify the contract upon sobering—for example, by making payments or continuing performance.

Remedies

1. Rescission: The intoxicated party may disaffirm the contract once sober, provided they act within a reasonable time.

2. Restitution: Courts often require the intoxicated party to return any benefits received (or pay reasonable value) to prevent unjust enrichment.
3. Necessaries: Even if voidable, the intoxicated person remains liable for the reasonable value of necessities furnished.
4. Protection of Good-Faith Counterparties: If the other party entered into the contract fairly and without knowledge of the intoxication, rescission may be conditioned on compensation.

Policy Note

Courts disfavor intoxication as a defense because individuals are expected to take responsibility for their actions unless impairment was extreme.

KEY TAKEAWAY

Infants may generally disaffirm their contracts up to the age of majority and within a reasonable time afterward, but the rule is subject to important exceptions: necessities, contracts made nonvoidable by statute, misrepresentation of age, extent of duty to return consideration, ratification, and torts connected with contracts.

Contracts made by persons who are mentally ill or intoxicated are generally voidable once the person regains competency. By contrast, a contract made by someone under guardianship is void, though the estate remains liable for necessities. Contracts entered while mentally ill or intoxicated may also be ratified once capacity is regained.

EXERCISES

1. Ivar, an infant, bought a used car—not a necessity—for $9,500. Seller took advantage of Ivar's infancy: the car was really worth only $5,500. Can Ivar keep the car but disclaim liability for the $4,000 difference?
2. If Ivar bought the car and it was a necessity, could he disclaim liability for the $4,000?
3. Alice Ace found her adult son's Christmas stocking; Mrs. Ace herself had made it fifty years before. It was considerably deteriorated. Isabel, sixteen, handy with knitting, agreed to reknit it for $100, which Mrs. Ace paid in advance. Isabel, regrettably, lost the stocking. She returned the $100 to Mrs. Ace, who was very upset. May Mrs. Ace now sue Isabel for the loss of the stocking (conversion) and emotional distress?
4. Why is voluntary intoxication a disfavored defense?

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10.5: Cases

Undue Influence

Hodge v. Shea

168 S.E.2d 82 (S.C. 1969)

Brailsford, J.

In this equitable action the circuit court decreed specific performance of a contract for the sale of land, and the defendant has appealed. The plaintiff is a physician, and the contract was prepared and executed in his medical office on August 19, 1965. The defendant had been plaintiff's patient for a number of years. On the contract date, he was seventy-five years of age, was an inebriate of long standing, and was afflicted by grievous chronic illnesses, including arteriosclerosis, cirrhosis of the liver, neuritises, arthritis of the spine and hip and varicose veins of the legs. These afflictions and others required constant medication and frequent medical attention, and rendered him infirm of body and mind, although not to the point of incompetency to contract.

During the period immediately before and after August 19, 1965, George A. Shea, the defendant, was suffering a great deal of pain in his back and hip and was having difficulty in voiding. He was attended professionally by the plaintiff, Dr. Joseph Hodge, either at the Shea home, at the doctor's office or in the hospital at least once each day from August 9 through August 26, 1965, except for August 17. The contract was signed during the morning of August 19. One of Dr. Hodge's frequent house calls was made on the afternoon of that day, and Mr. Shea was admitted to the hospital on August 21, where he remained until August 25.

Mr. Shea was separated from his wife and lived alone. He was dependent upon Dr. Hodge for house calls, which were needed from time to time. His relationship with his physician, who sometimes visited him as a friend and occasionally performed non-professional services for him, was closer than ordinarily arises from that of patient and physician....

"Where a physician regularly treats a chronically ill person over a period of two years, a confidential relationship is established, raising a presumption that financial dealings between them are fraudulent." [Citation]

A 125 acre tract of land near Mr. Shea's home, adjacent to land which was being developed as residential property, was one of his most valuable and readily salable assets. In 1962, the developer of this contiguous land had expressed to Mr. Shea an interest in it at $1000.00 per acre. A firm offer of this amount was made in November, 1964, and was refused by Mr. Shea on the advice of his son-in-law that the property was worth at least $1500.00 per acre. Negotiations between the developer and Mr. Ransdell commenced at that time and were in progress when Mr. Shea, at the instance of Dr. Hodge and without consulting Mr. Ransdell or anyone else, signed the contract of August 19, 1965. Under this contract Dr. Hodge claims the right to purchase twenty choice acres of the 125 acre tract for a consideration calculated by the circuit court to be the equivalent of $361.72 per acre. The market value of the land on the contract date has been fixed by an unappealed finding of the master at $1200.00 per acre....

The consideration was expressed in the contract between Dr. Hodge and Mr. Shea as follows:

The purchase price being (Cadillac Coupe DeVille 6600) & $4000.00 Dollars, on the following terms: Dr. Joseph Hodge to give to Mr. George Shea a new $6600 coupe DeVille Cadillac which is to be registered in name of Mr. George A. Shea at absolutely no cost to him. In return, Mr. Shea will give to Dr. Joe Hodge his 1964 Cadillac coupe DeVille and shall transfer title of this vehicle to Dr. Hodge. Further, Dr. Joseph Hodge will pay to Mr. George A. Shea the balance of $4000.00 for the 20 acres of land described above subject to survey, title check, less taxes on purchase of vehicle.

Dr. Hodge was fully aware of Mr. Shea's financial troubles, the liens on his property and his son-in-law's efforts in his behalf. He was also aware of his patient's predilection for new Cadillacs. Although he was not obligated to do so until the property was cleared of liens, which was not accomplished until the following June, Dr. Hodge hastened to purchase a 1965 Cadillac Coupe DeVille and delivered it to Mr. Shea on the day after his discharge from the hospital on August 25, 1965. If he acted in haste in an effort to fortify what he must have realized was a dubious contract, he has so far succeeded....

The case at hand is attended by gross inadequacy of consideration, serious impairment of the grantor's mentality from age, intemperance and disease, and a confidential relationship between the grantee and grantor. Has the strong presumption of vitiating unfairness arising from this combination of circumstances been overcome by the evidence? We must conclude that

it has not. The record is devoid of any evidence suggesting a reason, compatible with fairness, for Mr. Shea's assent to so disadvantageous a bargain. Disadvantageous not only because of the gross disparity between consideration and value, but because of the possibility that the sale would impede the important negotiations in which Mr. Ransdell was engaged. Unless his memory failed him, Mr. Shea knew that his son-in-law expected to sell the 125 acre tract for about $1500.00 per acre as an important step toward raising sufficient funds to satisfy the tax and judgment liens against the Shea property. These circumstances furnish strong evidence that Mr. Shea's assent to the contract, without so much as notice to Mr. Ransdell, was not the product of a deliberate Exercise of an informed judgment....

Finally, on this phase of the case, it would be naive not to recognize that the 1965 Cadillac was used to entice a highly susceptible old man into a hard trade. Mr. Shea was fatuously fond of new Cadillacs, but was apparently incapable of taking care of one. His own 1964 model (he had also had a 1963 model) had been badly abused. According to Dr. Hodge, it 'smelled like a toilet. * * * had several fenders bumped, bullet holes in the top and the car was just filthy * * *. It was a rather foul car.'...Knowing the condition of Mr. Shea's car, his financial predicament and the activities of his son-in-law in his behalf, Dr. Hodge used the new automobile as a means of influencing Mr. Shea to agree to sell. The means was calculated to becloud Mr. Shea's judgment, and, under the circumstances, its use was unfair....

Reversed and remanded.

CASE QUESTIONS

1. Why is it relevant that Mr. Shea was separated from his wife and lived alone?
2. Why is it relevant that it was his doctor who convinced him to sell the real estate?
3. Why did the doctor offer the old man a Cadillac as part of the deal?
4. Generally speaking, if you agree to sell your real estate for less than its real value, that's just a unilateral mistake and the courts will grant no relief. What's different here?

Misrepresentation by Concealment

Reed v. King

193 Cal. Rptr. 130 (Calif. Ct. App. 1983)

Blease, J.

In the sale of a house, must the seller disclose it was the site of a multiple murder? Dorris Reed purchased a house from Robert King. Neither King nor his real estate agents (the other named defendants) told Reed that a woman and her four children were murdered there ten years earlier. However, it seems "truth will come to light; murder cannot be hid long." (Shakespeare, Merchant of Venice, Act II, Scene II.) Reed learned of the gruesome episode from a neighbor after the sale. She sues seeking rescission and damages. King and the real estate agent defendants successfully demurred to her first amended complaint for failure to state a cause of action. Reed appeals the ensuing judgment of dismissal. We will reverse the judgment.

Facts

We take all issuable facts pled in Reed's complaint as true. King and his real estate agent knew about the murders and knew the event materially affected the market value of the house when they listed it for sale. They represented to Reed the premises were in good condition and fit for an "elderly lady" living alone. They did not disclose the fact of the murders. At some point King asked a neighbor not to inform Reed of that event. Nonetheless, after Reed moved in neighbors informed her no one was interested in purchasing the house because of the stigma. Reed paid $76,000, but the house is only worth $65,000 because of its past....

Discussion

Does Reed's pleading state a cause of action? Concealed within this question is the nettlesome problem of the duty of disclosure of blemishes on real property which are not physical defects or legal impairments to use.

Numerous cases have found non-disclosure of physical defects and legal impediments to use of real property are material. [Citation] However, to our knowledge, no prior real estate sale case has faced an issue of non-disclosure of the kind presented

here. Should this variety of ill-repute be required to be disclosed? Is this a circumstance where "non-disclosure of the fact amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing [?]" (Rest.2d Contracts, § 161, subd. (b).)

The paramount argument against an affirmative conclusion is it permits the camel's nose of unrestrained irrationality admission to the tent. If such an "irrational" consideration is permitted as a basis of rescission the stability of all conveyances will be seriously undermined. Any fact that might disquiet the enjoyment of some segment of the buying public may be seized upon by a disgruntled purchaser to void a bargain. In our view, keeping this genie in the bottle is not as difficult a task as these arguments assume. We do not view a decision allowing Reed to survive a demurrer in these unusual circumstances as endorsing the materiality of facts predicating peripheral, insubstantial, or fancied harms.

The murder of innocents is highly unusual in its potential for so disturbing buyers they may be unable to reside in a home where it has occurred. This fact may foreseeably deprive a buyer of the intended use of the purchase. Murder is not such a common occurrence that *buyers* should be charged with anticipating and discovering this disquieting possibility. Accordingly, the fact is not one for which a duty of inquiry and discovery can sensibly be imposed upon the buyer.

Reed alleges the fact of the murders has a quantifiable effect on the market value of the premises. We cannot say this allegation is inherently wrong and, in the pleading posture of the case, we assume it to be true. If information known or accessible only to the seller has a significant and measureable effect on market value and, as is alleged here, the seller is aware of this effect, we see no principled basis for making the duty to disclose turn upon the character of the information. Physical usefulness is not and never has been the sole criterion of valuation. Stamp collections and gold speculation would be insane activities if utilitarian considerations were the sole measure of value.

Reputation and history can have a significant effect on the value of realty. "George Washington slept here" is worth something, however physically inconsequential that consideration may be. Ill-repute or "bad will" conversely may depress the value of property. Failure to disclose such a negative fact where it will have a forseeably depressing effect on income expected to be generated by a business is tortuous. [Citation] Some cases have held that *unreasonable* fears of the potential buying public that a gas or oil pipeline may rupture may depress the market value of land and entitle the owner to incremental compensation in eminent domain.

Whether Reed will be able to prove her allegation the decade-old multiple murder has a significant effect on market value we cannot determine. If she is able to do so by competent evidence she is entitled to a favorable ruling on the issues of materiality and duty to disclose. Her demonstration of objective tangible harm would still the concern that permitting her to go forward will open the floodgates to rescission on subjective and idiosyncratic grounds....

The judgment is reversed.

CASE QUESTIONS

1. Why is it relevant that the plaintiff was "an elderly lady living alone"?
2. How did Mrs. Reed find out about the gruesome fact here?
3. Why did the defendants conceal the facts?
4. What is the concern about opening "floodgates to rescission on subjective and idiosyncratic grounds"?
5. Why *did* George Washington sleep in so many places during the Revolutionary War?
6. Did Mrs. Reed get to rescind her contract and get out of the house as a result of this case?

Misrepresentation by Assertions of Opinion

Vokes v. Arthur Murray, Inc.

212 S.2d. 906 (Fla. 1968)

Pierce, J.

This is an appeal by Audrey E. Vokes, plaintiff below, from a final order dismissing with prejudice, for failure to state a cause of action, her fourth amended complaint, hereinafter referred to as plaintiff's complaint.

Defendant Arthur Murray, Inc., a corporation, authorizes the operation throughout the nation of dancing schools under the name of

"Arthur Murray School of Dancing" through local franchised operators, one of whom was defendant J. P. Davenport whose dancing establishment was in Clearwater.

Plaintiff Mrs. Audrey E. Vokes, a widow of 51 years and without family, had a yen to be "an accomplished dancer" with the hopes of finding "new interest in life." So, on February 10, 1961, a dubious fate, with the assist of a motivated acquaintance, procured her to attend a "dance party" at Davenport's "School of Dancing" where she whiled away the pleasant hours, sometimes in a private room, absorbing his accomplished sales technique, during which her grace and poise were elaborated upon and her rosy future as "an excellent dancer" was painted for her in vivid and glowing colors. As an incident to this interlude, he sold her eight 1/2-hour dance lessons to be utilized within one calendar month therefrom, for the sum of $14.50 cash in hand paid, obviously a baited "come-on."

Thus she embarked upon an almost endless pursuit of the terpsichorean art during which, over a period of less than sixteen months, she was sold fourteen "dance courses" totaling in the aggregate 2302 hours of dancing lessons for a total cash outlay of $31,090.45 [about $220,000 in 2010 dollars] all at Davenport's dance emporium. All of these fourteen courses were evidenced by execution of a written "Enrollment Agreement-Arthur Murray's School of Dancing" with the addendum in heavy black print, "No one will be informed that you are taking dancing lessons. Your relations with us are held in strict confidence", setting forth the number of "dancing lessons" and the "lessons in rhythm sessions" currently sold to her from time to time, and always of course accompanied by payment of cash of the realm.

These dance lesson contracts and the monetary consideration therefore of over $31,000 were procured from her by means and methods of Davenport and his associates which went beyond the unsavory, yet legally permissible, perimeter of "sales puffing" and intruded well into the forbidden area of undue influence, the suggestion of falsehood, the suppression of truth, and the free Exercise of rational judgment, if what plaintiff alleged in her complaint was true. From the time of her first contact with the dancing school in February, 1961, she was influenced unwittingly by a constant and continuous barrage of flattery, false praise, excessive compliments, and panegyric encomiums, to such extent that it would be not only inequitable, but unconscionable, for a Court exercising inherent chancery power to allow such contracts to stand.

She was incessantly subjected to overreaching blandishment and cajolery. She was assured she had "grace and poise"; that she was "rapidly improving and developing in her dancing skill"; that the additional lessons would "make her a beautiful dancer, capable of dancing with the most accomplished dancers"; that she was "rapidly progressing in the development of her dancing skill and gracefulness", etc., etc. She was given "dance aptitude tests" for the ostensible purpose of "determining" the number of remaining hours of instructions needed by her from time to time.

At one point she was sold 545 additional hours of dancing lessons to be entitled to an award of the "Bronze Medal" signifying that she had reached "the Bronze Standard", a supposed designation of dance achievement by students of Arthur Murray, Inc....At another point, while she still had over 1,000 unused hours of instruction she was induced to buy 151 additional hours at a cost of $2,049.00 to be eligible for a "Student Trip to Trinidad", at her own expense as she later learned....

Finally, sandwiched in between other lesser sales promotions, she was influenced to buy an additional 481 hours of instruction at a cost of $6,523.81 in order to "be classified as a Gold Bar Member, the ultimate achievement of the dancing studio."

All the foregoing sales promotions, illustrative of the entire fourteen separate contracts, were procured by defendant Davenport and Arthur Murray, Inc., by false representations to her that she was improving in her dancing ability, that she had excellent potential, that she was responding to instructions in dancing grace, and that they were developing her into a beautiful dancer, whereas in truth and in fact she did not develop in her dancing ability, she had no "dance aptitude," and in fact had difficulty in "hearing that musical beat." The complaint alleged that such representations to her "were in fact false and known by the defendant to be false and contrary to the plaintiff's true ability, the truth of plaintiff's ability being fully known to the defendants, but withheld from the plaintiff for the sole and specific intent to deceive and defraud the plaintiff and to induce her in the purchasing of additional hours of dance lessons." It was averred that the lessons were sold to her "in total disregard to the true physical, rhythm, and mental ability of the plaintiff." In other words, while she first exulted that she was entering the "spring of her life", she finally was awakened to the fact there was "spring" neither in her life nor in her feet.

The complaint prayed that the Court decree the dance contracts to be null and void and to be cancelled, that an accounting be had, and judgment entered against, the defendants "for that portion of the $31,090.45 not charged against specific hours of instruction given to the plaintiff." The Court held the complaint not to state a cause of action and dismissed it with prejudice. We disagree and reverse.

It is true that "generally a misrepresentation, to be actionable, must be one of fact rather than of opinion." [Citations] But this rule has significant qualifications, applicable here. It does not apply where there is a fiduciary relationship between the parties,

or where there has been some artifice or trick employed by the representor, or where the parties do not in general deal at "arm's length" as we understand the phrase, or where the representee does not have equal opportunity to become apprised of the truth or falsity of the fact represented. [Citation] As stated by Judge Allen of this Court in [Citation]:

"* * * A statement of a party having * * * superior knowledge may be regarded as a statement of fact although it would be considered as opinion if the parties were dealing on equal terms."...

In [Citation] it was said that "* * * what is plainly injurious to good faith ought to be considered as a fraud sufficient to impeach a contract."... [Reversed.]

CASE QUESTIONS

1. What was the motivation of the "motivated acquaintance" in this case?
2. Why is it relevant that Mrs. Vokes was a "widow of 51 years and without family"?
3. How did the defendant J. P. Davenport entice her into spending a lot of money on dance lessons?
4. What was the defendants' defense as to why they should not be liable for misrepresentation, and why was that defense not good?
5. Would you say the court here is rather condescending to Mrs. Vokes, all things considered?

Mutual Mistake

Konic International Corporation v. Spokane Computer Services, Inc.,

708 P.2d 932 (Idaho 1985)

The magistrate found the following facts. David Young, an employee of Spokane Computer, was instructed by his employer to investigate the possibility of purchasing a surge protector, a device which protects computers from damaging surges of electrical current. Young's investigation turned up several units priced from $50 to $200, none of which, however, were appropriate for his employer's needs. Young then contacted Konic. After discussing Spokane Computer's needs with a Konic engineer, Young was referred to one of Konic's salesmen. Later, after deciding on a certain unit, Young inquired as to the price of the selected item. The salesman responded, "fifty-six twenty." The salesman meant $5,620. Young in turn thought $56.20.

The salesman for Konic asked about Young's authority to order the equipment and was told that Young would have to get approval from one of his superiors. Young in turn prepared a purchase order for $56.20 and had it approved by the appropriate authority. Young telephoned the order and purchase order number to Konic who then shipped the equipment to Spokane Computer. However, because of internal processing procedures of both parties the discrepancy in prices was not discovered immediately. Spokane Computer received the surge protector and installed it in its office. The receipt and installation of the equipment occurred while the president of Spokane Computer was on vacation. Although the president's father, who was also chairman of the board of Spokane Computer, knew of the installation, he only inquired as to what the item was and who had ordered it. The president came back from vacation the day after the surge protector had been installed and placed in operation and was told of the purchase. He immediately ordered that power to the equipment be turned off because he realized that the equipment contained parts which alone were worth more than $56 in value. Although the president then told Young to verify the price of the surge protector, Young failed to do so. Two weeks later, when Spokane Computer was processing its purchase order and Konic's invoice, the discrepancy between the amount on the invoice and the amount on the purchase order was discovered. The president of Spokane Computer then contacted Konic, told Konic that Young had no authority to order such equipment, that Spokane Computer did not want the equipment, and that Konic should remove it. Konic responded that Spokane Computer now owned the equipment and if the equipment was not paid for, Konic would sue for the price. Spokane Computer refused to pay and this litigation ensued.

Basically what is involved here is a failure of communication between the parties. A similar failure to communicate arose over 100 years ago in the celebrated case of *Raffles v. Wichelhaus*, [Citation] which has become better known as the case of the good ship "Peerless." In *Peerless*, the parties agreed on a sale of cotton which was to be delivered from Bombay by the ship "Peerless." In fact, there were two ships named "Peerless" and each party, in agreeing to the sale, was referring to a different ship. Because the sailing time of the two ships was materially different, neither party was willing to agree to shipment by the "other" Peerless. The court ruled that, because each party had a different ship in mind at the time of the contract, there was in fact no binding contract. The *Peerless* rule later was incorporated into section 71 of the Restatement of Contracts and has now evolved into section 20 of Restatement (Second) of Contracts (1981). Section 20 states in part:

(1) There is no manifestation of mutual assent to an exchange if the parties attach materially different meanings to their manifestations and

(a) neither knows or has reason to know the meaning attached by the other.

Comment (c) to Section 20 further explains that "even though the parties manifest mutual assent to the same words of agreement, there may be no contract because of a material difference of understanding as to the terms of the exchange." Another authority, Williston, discussing situations where a mistake will prevent formation of a contract, agrees that "where a phrase of contract...is reasonably capable of different interpretations...there is no contract." [Citation]

In the present case, both parties attributed different meanings to the same term, "fifty-six twenty." Thus, there was no meeting of the minds of the parties. With a hundred fold difference in the two prices, obviously price was a material term. Because the "fifty-six twenty" designation was a material term expressed in an ambiguous form to which two meanings were obviously applied, we conclude that no contract between the parties was ever formed. Accordingly, we do not reach the issue of whether Young had authority to order the equipment.

[Affirmed.]

CASE QUESTIONS

1. Why is it reasonable to say that no contract was made in this case?
2. A discrepancy in price of one hundred times is, of course, enormous. How could such an egregious mistake have occurred by both parties? In terms of running a sensible business, how could this kind of mistake be avoided before it resulted in expensive litigation?

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10.6: Summary and Exercises

Summary

No agreement is enforceable if the parties did not enter into it (1) of their own free will, (2) with adequate knowledge of the terms, and (3) with the mental capacity to appreciate the relationship.

Contracts coerced through duress will void a contract if actually induced through physical harm and will make the contract voidable if entered under the compulsion of many types of threats. The threat must be improper and leave no reasonable alternative, but the test is subjective—that is, what did the person threatened actually fear, not what a more reasonable person might have feared.

Misrepresentations may render an agreement void or voidable. Among the factors to be considered are whether the misrepresentation was deliberate and material; whether the promisee relied on the misrepresentation in good faith; whether the representation was of fact, opinion, or intention; and whether the parties had a special relationship.

Similarly, mistaken beliefs, not induced by misrepresentations, may suffice to avoid the bargain. Some mistakes on one side only make a contract voidable. More often, mutual mistakes of facts will show that there was no meeting of the minds.

Those who lack capacity are often entitled to avoid contract liability. Although it is possible to state the general rule, many exceptions exist—for example, in contracts for necessities, infants will be liable for the reasonable value of the goods purchased.

EXERCISES

1. Eulrich, an auto body mechanic who had never operated a business, entered into a Snap-On Tools franchise agreement. For $22,000 invested from his savings and the promise of another $22,000 from the sale of inventory, he was provided a truck full of tools. His job was to drive around his territory and sell them. The agreement allowed termination by either party; if Eulrich terminated, he was entitled to resell to Snap-On any new tools he had remaining. When he complained that his territory was not profitable, his supervisors told him to work it harder, that anybody could make money with Snap-On's marketing system. (In fact, the evidence was the system made money for the supervisors and little for dealers; dealers quickly failed and were replaced by new recruits.) Within several months Eulrich was out of money and desperate. He tried to "check in" his truck to get money to pay his household bills and uninsured medical bills for his wife; the supervisors put him off for weeks. On the check-in day, the exhausted Eulrich's supervisors berated him for being a bad businessman, told him no check would be forthcoming until all the returned inventory was sold, and presented him with a number of papers to sign, including a "Termination Agreement" whereby he agreed to waive any claims against Snap-On; he was not aware that was what he had signed. He sued to rescind the contract and for damages. The defendants held up the waiver as a defense. Under what theory might Eulrich recover?*Eulrich v. Snap-On Tools Corp.*, 853 P.2d 1350 (Or. Ct. App. 1993).
2. Chauncey, a college student, worked part-time in a restaurant. After he had worked for several months, the owner of the restaurant discovered that Chauncey had stolen $2,000 from the cash register. The owner called Chauncey's parents and told them that if they did not sign a note for $2,000, he would initiate criminal proceedings against Chauncey. The parents signed and delivered the note to the owner but later refused to pay. May the owner collect on the note? Why?
3. A restaurant advertised a steak dinner that included a "juicy, great-tasting steak, a fresh crisp salad, and a warm roll." After reading the ad, Clarence visited the restaurant and ordered the steak dinner. The steak was dry, the lettuce in the salad was old and limp with brown edges, and the roll was partly frozen. May Clarence recover from the restaurant on the basis of misrepresentation? Why?
4. Bert purchased Ernie's car. Before selling the car, Ernie had stated to Bert, "This car runs well and is reliable. Last week I drove the car all the way from Seattle to San Francisco to visit my mother and back again to Seattle." In fact, Ernie was not telling the truth: he had driven the car to San Francisco to visit his paramour, not his mother. Upon discovery of the truth, may Bert avoid the contract? Why?
5. Randolph enrolled in a business law class and purchased a new business law textbook from the local bookstore. He dropped the class during the first week and sold the book to his friend Scott. Before making the sale, Randolph told Scott that he had purchased the book new and had owned it for one week. Unknown to either Randolph or Scott, the book was in fact a used one. Scott later discovered some underlining in the middle of the book and attempted to avoid the contract. Randolph refused to refund the purchase price, claiming that he had not intentionally deceived his friend. May Scott avoid the contract?

Why?

6. Langstraat was seventeen when he purchased a motorcycle. When applying for insurance, he signed a "Notice of Rejection," declining to purchase uninsured motorist coverage. He was involved in an accident with an uninsured motorist and sought to disaffirm his rejection of the uninsured motorist coverage on the basis of infancy. May he do so?
7. Waters was attracted to Midwest Supply by its advertisements for doing federal income taxes. The ads stated "guaranteed accurate tax preparation." Waters inquired about amending past returns to obtain refunds. Midwest induced him to apply for and receive improper refunds. When Waters was audited, he was required to pay more taxes, and the IRS put tax liens on his wages and bank accounts. In fact, Midwest hired people with no knowledge about taxes at all; if a customer inquired about employees' qualifications, Midwest's manual told the employees to say, "Midwest has been preparing taxes for twenty years." The manual also instructed office managers never to refer to any employee as a "specialist" or "tax expert," but never to correct any news reporters or commentators if they referred to employees as such. What cause of action has Waters, and for what remedies?
8. Mutschler Grain Company (later Jamestown Farmers Elevator) agreed to sell General Mills 30,000 bushels of barley at $1.22 per bushel. A dispute arose: Mutschler said that transportation was to be by truck but that General Mills never ordered any trucks to pick up the grain; General Mills said the grain was to be shipped by rail (railcars were in short supply). Nine months later, after Mutschler had delivered only about one-tenth the contracted amount, the price of barley was over $3.00 per bushel. Mutschler defaulted on, and then repudiated, the contract. Fred Mutschler then received this telephone call from General Mills: "We're General Mills, and if you don't deliver this grain to us, why we'll have a battery of lawyers in there tomorrow morning to visit you, and then we are going to the North Dakota Public Service (Commission); we're going to the Minneapolis Grain Exchange and we're going to the people in Montana and there will be no more Mutschler Grain Company. We're going to take your license."

   Mutchsler then shipped 22,000 bushels of barley at the $1.22 rate and sued General Mills for the difference between that price and the market price of over $3.00. Summary judgment issued for General Mills. Upon what basis might Mutschler Grain appeal?

9. Duke decided to sell his car. The car's muffler had a large hole in it, and as a result, the car made a loud noise. Before showing the car to potential buyers, Duke patched the hole with muffler tape to quiet it. Perry bought the car after test-driving it. He later discovered the faulty muffler and sought to avoid the contract, claiming fraud. Duke argued that he had not committed fraud because Perry had not asked about the muffler and Duke had made no representation of fact concerning it. Is Duke correct? Decide and explain.
10. At the end of the term at college, Jose, talking in the library with his friend Leanne, said, "I'll sell you my business law notes for $25." Leanne agreed and paid him the money. Jose then realized he'd made a mistake in that he had offered his notes when he meant to offer his book. Leanne didn't want the book; she had a book. She wanted the notes. Would Leanne have a cause of action against Jose if he refused to deliver the notes? Decide and explain.

SELF-TEST QUESTIONS

1. Misrepresentation that does not go to the core of a contract is
   1. fraud in the execution
   2. fraud in the inducement
   3. undue influence
   4. an example of mistake
2. In order for a misrepresentation to make a contract voidable,
   1. it must have been intentional
   2. the party seeking to void must have relied on the misrepresentation
   3. it must always be material
   4. none of the above is required
3. A mistake by one party will not invalidate a contract unless
   1. the other party knew of the mistake
   2. the party making the mistake did not read the contract closely
   3. the parties to the contract had never done business before
   4. the party is mistaken about the law
4. Upon reaching the age of majority, a person who entered into a contract to purchase goods while a minor may
   1. ratify the contract and keep the goods without paying for them
   2. disaffirm the contract and keep the goods without paying for them
   3. avoid paying for the goods by keeping them without ratifying or disaffirming the contract
   4. none of these

5. Seller does not disclose to Buyer that the foundation of a house is infested with termites. Upon purchasing the house and remodeling part of the basement, Buyer discovers the termites. Has Buyer a cause of action against Seller?
    1. yes
    2. no

SELF-TEST AnswerS

1. a
2. d
3. a
4. e
5. b

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11: LEGALITY

Learning Objectives

After reading this chapter, you should understand the following:

- The types of contracts (bargains) that are deemed illegal
- How courts deal with disputes concerning illegal contracts
- Under what circumstances courts will enforce otherwise illegal contracts

11.1: General Perspectives on Illegality

11.2: Agreements in Violation of Statute

11.3: Bargains Made Illegal by Common Law

11.4: Effect of Illegality and Exceptions

11.5: Cases

11.6: Summary and Exercises

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11.1: General Perspectives on Illegality

LEARNING OBJECTIVES

1. Understand why courts refuse to enforce illegal agreements.
2. Recognize the rationale behind exceptions to the rule.

Introduction: Why Legality Matters

We have discussed the requirements of mutual assent, real assent, and consideration. **We now turn to the legality of the underlying bargain.** The basic rule is that courts will not enforce an illegal bargain. (The term illegal bargain is better than illegal contract because a contract is by definition a legal agreement, but the latter terminology prevails in common usage.) Why should this be? Why should the courts refuse to honor contracts made privately by people who presumably know what they are doing—for example, a wager on the World Series or a championship fight? Two reasons are usually given:

1. **Deterrence** – Denying enforcement helps discourage unlawful behavior.
2. **Integrity of the Courts** – Enforcing illegal agreements would sully the reputation of the judiciary by giving legitimacy to unlawful conduct.

Judicial Rationale

One contracts scholar explained it this way:

[D]enying relief to parties who have engaged in an illegal transaction...helps to effectuate the public policy involved by discouraging the conduct that is disapproved. Mere denial of contractual and quasi-contractual remedy [however] rarely has a substantial effect in discouraging illegal conduct. A man who is hired to perform a murder is not in the least deterred by the fact that the courts are not open to him to collect his fee. Such a man has other methods of enforcement, and they are in fact more effective than legal process. The same is true in varying degrees where less heinous forms of illegal conduct are involved. Even in the matter of usury it was found that mere denial of enforcement was of little value in the effort to eliminate the loan shark. And restraints of trade were not curbed to an appreciable extent until contracts in restraint of trade were made criminal.

The Harshness of the Rule

Strict enforcement of the illegality rule can be harsh. If one party has already performed under an illegal contract—say, paying money or providing services—they cannot recover what they gave, nor compel the other side to perform. The court simply leaves the parties **where it finds them.**

Example:

- If Alice pays Bob $5,000 to fix a horse race (illegal conduct), but Bob never does so, Alice cannot sue Bob to get her money back. Even though Bob received an uncompensated benefit, the court will not intervene.

Exceptions to the Rule

Because this strict approach can be unfair, courts have developed **exceptions**—usually grounded in the principle of **restitution** (preventing unjust enrichment).

1. **Excusable Ignorance**
   - A party who is unaware that their promise violates public policy may recover.
   - Example: Carla contracts with Dave to transport goods, not knowing that Dave intends to smuggle contraband. Carla may be able to recover payment for her legitimate services.
2. **Unequal Fault (Not in Pari Delicto)**

- If one party is less blameworthy than the other, recovery may be allowed.
- Example: An unlicensed worker contracts with a sophisticated business owner who knows of the worker's status. Courts may permit the worker to recover wages if the employer clearly took advantage.

3. **Avoiding Forfeiture Disproportionate to the Wrong**
   - If denial of recovery would cause extreme forfeiture disproportionate to the violation, restitution may be granted.
   - Example: A minor violation of a licensing law may not bar a contractor from recovering substantial payment for completed work.
4. **Withdrawal Before Performance**
   - If a party withdraws from the illegal agreement before it is carried out, they may recover what was paid or transferred.
   - Example: Two gamblers deposit money with a stakeholder for an unlawful bet. Before the race occurs, one gambler changes his mind and demands his money back. The court will allow recovery.
5. **Ending a Continuing Illegal Situation**
   - If allowing restitution will terminate an ongoing violation, courts are more likely to step in.
   - Example: A gambler seeks recovery of money placed in the hands of a bookmaker before it is paid out to the winner. Courts may allow recovery to end the illegal situation.

Statutes and Public Policy Concerns

Beyond agreements expressly prohibited by law (like wagers, usury, or bribery), courts may also refuse enforcement where bargains conflict with broader **public policy.**

Examples of Statutory or Public Policy Restrictions:

- **Medical Licensing Laws:** A patient cannot legally contract with an unlicensed herbalist for surgical care.
- **Restraint of Trade:** Contracts that unreasonably limit competition may be unenforceable.
- **Domestic Relations:** Contracts encouraging divorce or interfering with parental duties are void.
- **Corruption and Justice:** Agreements to obstruct justice, commit perjury, or engage in bribery are unenforceable.

KEY TAKEAWAY

Courts refuse to enforce illegal bargains—even when both parties consent—because they will not reward unlawful conduct or tarnish the reputation of the judiciary by enforcing forbidden deals. However, fairness sometimes compels exceptions. Through doctrines of restitution and public policy balancing, courts may allow recovery in cases of excusable ignorance, unequal fault, withdrawal before performance, or when preventing forfeiture or ending continuing illegality.

EXERCISES

1. Why is *illegal contract* a contradiction in terms?
2. Why do courts refuse to enforce contracts (or bargains) made by competent adults if the contracts harm no third party but are illegal?

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11.2: Agreements in Violation of Statute

LEARNING OBJECTIVES

1. Understand that various types of bargains may be made illegal by statute, including gambling, some service-for-fee agreements involving unlicensed practitioners, and usury.
2. Recognize that while gambling contracts are often illegal, some agreements that might appear to involve gambling are not.

Overview

Not every agreement is legally enforceable. Even when the parties mutually assent and provide consideration, the law will not uphold certain bargains because they violate statutes designed to protect the public. These statutes reflect the legislature's determination that some agreements are contrary to public health, safety, morals, or welfare.

The most common categories of bargains made illegal by statute include:

1. Gambling contracts
2. Sunday contracts (blue laws)
3. Usury
4. Unlicensed services

Types of Bargains Made Illegal by Statute

1. Gambling Contracts

General Rule: Gambling contracts are generally unenforceable. A gambling contract is one in which the parties wager on the outcome of an uncertain event outside their control. Courts have long refused to enforce these agreements because gambling can encourage addiction, attract organized crime, and lead to financial ruin.

- **What counts as gambling?**
  Betting on roulette, poker, or the outcome of a horse race or football game.

- **What does not count as gambling?**
  Agreements involving risk but structured as legitimate bargains.

  - *Example (not gambling):* A gardener agrees to maintain an elderly client's lawn for the rest of the client's life in exchange for an upfront payment. The duration of the service is uncertain, but this is a life-service contract, not gambling.
  - *Example (not gambling):* A father promises to pay his daughter $50 if she earns an "A" in chemistry. This is a unilateral contract: the daughter controls the outcome through effort, not chance.

Exceptions:

- **Securities:** Buying stock in a corporation is speculative but socially useful; it encourages investment and entrepreneurship.
- **Insurance:** Risk-based, but enforceable only when the buyer has an *insurable interest* (e.g., life insurance on your spouse, not on a stranger).

2. Sunday Contracts (Blue Laws)

Background: Historically, many states enacted "blue laws" prohibiting contracts, sales, and other business transactions on Sundays, reflecting religious and cultural traditions of the time.

- Early blue laws restricted work, travel, sports, entertainment, and trade on Sundays.

- Exceptions often included contracts for necessities, marriage, or charitable purposes.
- These laws were widely enforced in the 18th and 19th centuries.

Modern Trend: Most blue laws have been repealed or fallen into disuse as society shifted toward consumer convenience and secular values. However, remnants remain in some states.

- *Example:* Until 2008, Washington State prohibited the sale of hard alcohol on Sundays. The law was repealed primarily to generate additional tax revenue.
- *Example:* Some counties in Texas and Indiana still limit alcohol sales on Sundays, a lingering effect of blue law traditions.

3. Usury

Definition: Usury occurs when a lender charges interest in excess of the maximum rate permitted by state law. Usury statutes aim to protect borrowers from exploitative lending practices.

Penalties: Vary by jurisdiction and may include forfeiture of:

- Only the interest,
- Both interest and principal, or
- In extreme cases, statutory penalties against the lender.

Modern Developments:

- Many states have relaxed usury laws to accommodate modern lending practices, especially for credit cards and corporate loans.
- Some high-interest loans (payday loans, pawnshop loans) operate under statutory exceptions.

Key Case: *Marquette National Bank v. First Omaha Service Corp.* (1978)

- The U.S. Supreme Court ruled that national banks may charge the highest interest rate allowed in their *home state*, even to borrowers in stricter states.
- *Example:* Citibank moved its credit card operations to South Dakota (which had no usury cap) to escape New York's strict limits.

Practical Example: If a payday lender charges 30% interest in a state with a 20% cap, the loan may be unenforceable. However, if issued by a national bank in a state with no cap, the interest may be legal under *Marquette*.

4. Licensing Statutes

States require professional licenses for many occupations. The effect of failing to hold a license depends on whether the statute is **regulatory** or **revenue-raising.**

1. **Regulatory Licenses (Protecting the Public):**
    - Designed to safeguard health, safety, and welfare by ensuring competence.
    - Professions: lawyers, doctors, accountants, electricians, contractors.
    - **Rule:** A person without a required regulatory license generally cannot enforce a contract for services.
        - *Example:* An unlicensed electrician performs wiring in a home. Even if the work is excellent, the electrician cannot sue for payment because the licensing requirement protects public safety.
2. **Revenue Licenses (Raising Funds or Recordkeeping):**
    - Require only a fee and registration, not proof of skill or training.
    - Professions: taxi drivers, milk delivery services, street vendors.
    - **Rule:** Failure to obtain a revenue license does not always bar recovery; courts may allow collection once the license is obtained.
        - *Example:* A vendor who fails to renew a city business license may still collect payment for goods already delivered, since the license is mainly for revenue purposes.

Analysis Framework for Courts:

1. Is a license required by statute?
2. Does the statute expressly prohibit recovery without a license?
3. If silent, is the license regulatory (bar recovery) or revenue-raising (may allow recovery)?

KEY TAKEAWAY

Statutory illegality covers contracts made unenforceable by specific laws, such as gambling prohibitions, blue laws, usury caps, and licensing requirements. Courts distinguish between bargains that pose risks society has chosen to tolerate (like securities and insurance) and those that undermine public policy. The effect of illegality varies: some contracts are void outright, while others may allow limited recovery, especially where fairness or restitution concerns apply.

EXERCISES

1. List the typical kinds of contracts made illegal by statute.
2. Why are some practitioners completely prohibited from collecting a fee for service if they don't have a license, and others allowed to collect the fee after they get the license?
3. If no competency test is required, why do some statutes require the practitioner to be licensed?

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11.3: Bargains Made Illegal by Common Law

LEARNING OBJECTIVE

1. Understand what contracts or bargains have been declared illegal by courts.

Overview

Public policy is shaped not only by legislatures but also by courts. When there is no specific statute, courts must balance competing interests: the parties' expectations, fairness, and forfeitures on one side, against the strength of public policy and the seriousness of the violation on the other.

The **Restatement (Second) of Contracts, Section 178**, provides a framework for this balancing test. Ultimately, courts will refuse to enforce agreements that contradict important public policies.

Imagine this scenario:
Samantha, the owner of a successful bakery chain, sells her business to Leo, including the name, recipes, and goodwill. As part of the sale, she agrees not to open another bakery in the same city for five years. Later, Samantha grows restless and opens a coffee shop that begins selling baked goods identical to those from her old bakery. At the same time, one of Leo's employees, Bruce, leaves and starts a competing bakery across town, despite signing a noncompete clause.

Both Samantha and Bruce now raise questions of public policy. Should the courts enforce their promises? On one hand, Leo expected protection when he purchased the business and when he hired Bruce. On the other hand, courts must ensure restrictions are fair, not overbroad, and consistent with public policy.

This illustrates the balancing role courts play when no specific statute governs. According to the *Restatement (Second) of Contracts §178*, courts weigh the parties' expectations and fairness against the strength of public policy and the seriousness of the violation. If a bargain contradicts important public policies, it will not be enforced.

Types of Bargains Made Illegal by Common Law

Common-Law Restraint of Trade

General Rule:
At common law, unreasonable restraints on trade have long been prohibited. What counts as "unreasonable" depends on whether the restriction is broader than necessary to protect a legitimate business interest. Today, antitrust laws (e.g., Sherman Act, Clayton Act) govern most large-scale restraints like price-fixing and market division, but the common-law principles remain in effect for individual agreements.

- **Not all restraints are unlawful—only those that are unreasonable.**
- A restraint is valid if it is **ancillary** (tied to a legitimate transaction) and **reasonable** in scope, geography, and time.

Sale of a Business

When Samantha sold her bakery, Leo bought not only the physical store but also the goodwill and loyal customer base. To protect that investment, a covenant not to compete is enforceable if it is reasonable.

Reasonableness Test:

1. **Scope of Activity:** Samantha can be restricted from opening another bakery, but not from unrelated ventures like a bookstore.
    - *Example:* Courts upheld a restriction preventing a dentist who sold his practice from practicing dentistry in the same

town, but not from selling dental supplies.
2. **Geographic Area:** Restrictions should cover the territory where the original business operated.
   - *Example:* A neighborhood bakery might justify a two-mile radius, while a statewide chain could justify a broader territory.
3. **Duration:** Restrictions must last only as long as needed to protect the buyer's interests—usually one to three years.
   - *Example:* Samantha's five-year ban may be upheld if the court finds it reasonable, but a 20-year ban would almost certainly be invalid.

Employment Noncompete Agreements

Bruce's situation—leaving Leo's company to start a competing bakery—raises another restraint issue. Employers use noncompetes to protect trade secrets, confidential information, or customer relationships.

- **Courts scrutinize employment noncompetes carefully** because they may unfairly limit employees' ability to earn a living.
- **Enforceable if reasonable:** For example, barring Bruce from opening a competing bakery within 10 miles for one year may be reasonable.
- **Overbroad examples:** Preventing Bruce from working in any food-related business nationwide for five years would almost certainly be struck down.

State Variations:

- California (Bus. & Prof. Code §16600) prohibits almost all noncompetes in employment, reflecting a strong public policy favoring worker mobility.
- Other states allow them if narrowly tailored. Some courts apply the "blue-pencil rule" to strike only the overbroad terms, while others may rewrite (reform) the agreement.

Unconscionable Contracts

Unconscionability protects weaker parties from oppressive bargains. Courts look at:

1. **Procedural unconscionability** – Problems in the bargaining process, such as hidden fine print, lack of opportunity to understand terms, or unequal bargaining power.
2. **Substantive unconscionability** – Harsh or one-sided terms that shock the conscience.

Example: *Williams v. Walker-Thomas Furniture Co.* (1965) – The furniture store's installment contract allowed repossession of everything the buyer had ever purchased upon default of one item. The court struck down the term as unconscionable.

Modern Example: A cell phone contract that hides exorbitant cancellation fees in unreadable fine print could be procedurally and substantively unconscionable.

Exculpatory Clauses

An exculpatory clause excuses one party from liability. Courts disfavor them, especially when:

- They attempt to excuse intentional or reckless harm, or
- They involve essential services (housing, medical care, public transportation).

When unenforceable:

- A hospital cannot avoid liability for reckless surgery errors.
- A landlord cannot require tenants to waive liability for negligent building maintenance (*Henrioulle v. Marin Ventures, Inc.*, Cal. 1978).

When enforceable:

- A ski resort requiring a liability waiver for ordinary accidents.

- A gym membership contract disclaiming liability for minor injuries.

Factors courts consider: clarity, conspicuousness, bargaining power, and whether the service is essential.

Family Relations

Contracts interfering with marriage or family obligations are void.

- **Unenforceable:** A father promises $100,000 to his daughter if she never marries.
- **Enforceable:** A postnuptial promise to provide support while a spouse remains unmarried after death.
- **Separation agreements:** Valid if fair and entered into voluntarily.
- **Child custody contracts:** Always subject to the child's best interest, regardless of parents' private agreements.

KEY TAKEAWAY

Courts refuse to enforce bargains that contradict public policy, even without a statute. Restraints of trade may be valid if reasonable, but overly broad noncompetes and covenants will be struck down. Unconscionable contracts, unfair exculpatory clauses, and agreements interfering with family relations are also void. Courts balance freedom of contract against fairness, worker mobility, consumer protection, and societal values.

EXERCISES

1. Why are employment noncompete agreements viewed less favorably than sale-of-business noncompete agreements?
2. Can a person by contract exculpate herself from liability for gross negligence? For ordinary negligence?
3. A parking lot agreement says the parking lot is "not responsible for loss of contents or damage to the vehicle." Is that acceptable? Explain.
4. A valet parking lot agreement—where the car owner gives the keys to the attendant who parks the car—has the same language as that for the lot in Exercise 3. Is that acceptable? Explain.

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11.4: Effect of Illegality and Exceptions

LEARNING OBJECTIVES

1. Recognize that courts will not enforce illegal bargains.
2. Know that there are exceptions to that rule.

Effect of Illegality

The **general rule** is straightforward: **courts will not enforce illegal bargains.** The policy is one of nonintervention—the law adopts a *hands-off* approach, leaving the parties as it finds them. If an agreement is illegal, it is **void**, and neither party may obtain relief, even if this results in one party receiving a windfall.

This principle is rooted in the maxim *ex turpi causa non oritur actio* ("no cause of action arises from a base cause"). In other words, the judiciary refuses to lend its authority to agreements that contradict the law or public policy.

Example – Licensing Statutes (California Law):
In *Pacific Custom Pools, Inc. v. Turner Construction* (2000), a contractor required by statute to hold a license built a waterslide. When the plaintiff discovered the contractor was unlicensed, they refused to pay the remaining $80,000. The court denied recovery to the contractor, emphasizing that California's **Business & Professions Code §7031** bars unlicensed contractors from suing for compensation, even if the work was perfectly completed.

Example – Unlicensed Professionals (Illinois Law):
In *Ransburg v. Haase* (1992), a man fraudulently represented himself as a licensed architect in Illinois, where licensing is required to protect public safety. He was paid $80,000 for designing a $900,000 house, but the project was late, over budget, and violated zoning laws. The court held that because he lacked the required license, he could not keep his fee.

These examples show how harsh the rule can be: a party may perform significant work but walk away with nothing if the bargain violates statutory requirements.

Exceptions

While the general rule is harsh, courts recognize that rigid application can lead to unjust results. Over time, exceptions have developed where fairness and public policy warrant relief.

1. Party Withdrawing before Performance

If a party repents and withdraws from an illegal contract before it is carried out, they may recover any consideration already paid. The rationale is to encourage abandonment of unlawful arrangements.

- **Example – Wager:** Samantha and Carlene agree to bet on a soccer game and deposit money with a stakeholder. Before the game concludes, Carlene withdraws. She can recover her money.
- **Example – Bribery Attempt:** Ralph pays Jacob $5,000 to bribe a juror. Before the bribe is attempted, Ralph changes his mind. He may reclaim his money.

This principle aligns with *Restatement (Second) of Contracts §182*, which allows restitution when a party withdraws before the illegal purpose is achieved.

2. Party Protected by Statute

When a statute makes an agreement illegal in order to protect a certain class of persons, that class may still recover despite the illegality.

- **Example – Employment Law:** A federal statute limits airline pilots' hours. If a pilot works overtime despite the prohibition, she may still recover wages owed.
- **Example – Securities Law:** Contracts for the sale of unregistered securities are illegal under federal securities law, but buyers are given an explicit right of rescission (return of their money).
- **Example – Fee Limits:** In one case, an attorney charged a client more than permitted by statute in helping obtain a government pension. The excess was recoverable by the client, even though the contract exceeded statutory limits.

Here, the illegality is meant to shield vulnerable parties, not punish them.

3. Party Not Equally at Fault (Doctrine of *In Pari Delicto*)

Where the parties are not equally blameworthy, the less guilty party may recover.

- **Example – Duress or Fraud:** If one party induces another to sign an illegal agreement by fraud, undue influence, or duress, the victim may rescind and recover any consideration already paid.
- **Illustration:** A company tricks a small vendor into signing a contract requiring them to engage in unlawful price-fixing. The vendor may later recover payments or avoid obligations because they were not equally at fault.

4. Excusable Ignorance

A person who unknowingly enters into an illegal contract, without reason to know of the illegality, may recover.

- **Example – Bigamy:** A woman marries a man not knowing he is already married. Because bigamy is illegal, the marriage is void. However, she may sue for damages, as she was ignorant of the illegality.
- **Example – Innocent Laborer:** A worker hired to move sealed crates later discovers they contained marijuana. Since he did not know and had no reason to know the contents, he may still recover payment for his labor.

This exception reflects *Restatement (Second) of Contracts §180*, which allows recovery where one party is excusably ignorant.

5. Partial Illegality

If only part of a contract is illegal, courts may sever the unlawful provision and enforce the remainder, provided the legal parts can stand independently.

- **Example – Employment Contract:** A six-page employment agreement includes an overly broad noncompete clause. The court may strike out the invalid noncompete but enforce the remainder of the contract (salary, duties, etc.).
- **Example – Loan Agreement:** If a loan contract has an illegal usury clause, the court may void the usurious interest term but enforce repayment of the principal with lawful interest.

This doctrine is recognized in *Restatement (Second) of Contracts §184*.

KEY TAKEAWAY

The **default rule** is that illegal contracts are void, and courts will not aid either party. However, strict application may sometimes produce unjust results. Exceptions exist when a party withdraws before performance, when the law was designed to protect one side, when the parties are not equally at fault, when one is excusably ignorant, or when only part of the contract is illegal. These exceptions strike a balance between deterring unlawful agreements and preventing disproportionate forfeitures.

EXERCISES

1. When, in general, will a court allow a party relief from an illegal contract (or bargain)?
2. A and B engage in a game of high-stakes poker under circumstances making the game illegal in the jurisdiction. A owes B $5,000 when A loses. When A does not pay, B sues. Does B get the money? What if A had paid B the $5,000 and then sued to get it back?

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11.5: Cases

Extension of Statutory Illegality Based on Public Policy

Bovard v. American Horse Enterprises

247 Cal. Rptr. 340 (Calif. 1988)

[Bovard sued Ralph and American Horse Enterprises (a corporation) to recover on promissory notes that were signed when Ralph purchased the corporation, ostensibly a jewelry-making business. The trial court dismissed Bovard's complaint.]

Puglia, J.

The court found that the corporation predominantly produced paraphernalia used to smoke marijuana [roach clips and bongs] and was not engaged significantly in jewelry production, and that Bovard had recovered the corporate machinery through self-help [i.e., he had repossessed it]. The parties do not challenge these findings. The court acknowledged that the manufacture of drug paraphernalia was not itself illegal in 1978 when Bovard and Ralph contracted for the sale of American Horse Enterprises, Inc. However, the court concluded a public policy against the manufacture of drug paraphernalia was implicit in the statute making the possession, use and transfer of marijuana unlawful. The trial court held the consideration for the contract was contrary to the policy of express law, and the contract was therefore illegal and void. Finally, the court found the parties were in pari delicto [equally at fault] and thus with respect to their contractual dispute should be left as the court found them.

The trial court concluded the consideration for the contract was contrary to the policy of the law as expressed in the statute prohibiting the possession, use and transfer of marijuana. Whether a contract is contrary to public policy is a question of law to be determined from the circumstances of the particular case. Here, the critical facts are not in dispute. Whenever a court becomes aware that a contract is illegal, it has a duty to refrain from entertaining an action to enforce the contract. Furthermore the court will not permit the parties to maintain an action to settle or compromise a claim based on an illegal contract....

[There are several] factors to consider in analyzing whether a contract violates public policy: "Before labeling a contract as being contrary to public policy, courts must carefully inquire into the nature of the conduct, the extent of public harm which may be involved, and the moral quality of the conduct of the parties in light of the prevailing standards of the community [Citations]"

These factors are more comprehensively set out in the Restatement Second of Contracts section 178:

(1) A promise or other term of an agreement is unenforceable on grounds of public policy if legislation provides that it is unenforceable or the interest in its enforcement is clearly outweighed in the circumstances by a public policy against the enforcement of such terms.

(2) In weighing the interest in the enforcement of a term, account is taken of

(a) the parties' justified expectations,

(b) any forfeiture that would result if enforcement were denied, and

(c) any special public interest in the enforcement of the particular term.

(3) In weighing a public policy against enforcement of a term, account is taken of

(a) the strength of that policy as manifested by legislation or judicial decisions,

(b) the likelihood that a refusal to enforce the term will further that policy,

(c) the seriousness of any misconduct involved and the extent to which it was deliberate, and

(d) the directness of the connection between that misconduct and the term.

Applying the Restatement test to the present circumstances, we conclude the interest in enforcing this contract is very tenuous. Neither party was reasonably justified in expecting the government would not eventually act to geld American Horse Enterprises, a business harnessed to the production of paraphernalia used to facilitate the use of an illegal drug. Moreover, although voidance of the contract imposed a forfeiture on Bovard, he did recover the corporate machinery, the only assets of the business which could be used for lawful purposes, i.e., to manufacture jewelry. Thus, the forfeiture was significantly mitigated if not negligible. Finally, there is no special public interest in the enforcement of this contract, only the general interest in preventing a party to a contract from avoiding a debt.

On the other hand, the Restatement factors favoring a public policy against enforcement of this contract are very strong. As we have explained, the public policy against manufacturing paraphernalia to facilitate the use of marijuana is strongly implied in the statutory prohibition against the possession, use, etc., of marijuana, a prohibition which dates back at least to 1929....Obviously, refusal to enforce the instant contract will further that public policy not only in the present circumstances but by serving notice on manufacturers of drug paraphernalia that they may not resort to the judicial system to protect or advance their business interests. Moreover, it is immaterial that the business conducted by American Horse Enterprises was not expressly prohibited by law when Bovard and Ralph made their agreement since both parties knew that the corporation's products would be used primarily for purposes which were expressly illegal. We conclude the trial court correctly declared the contract contrary to the policy of express law and therefore illegal and void.

CASE QUESTIONS

1. Why did the court think it was significant that Bovard had repossessed the jewelry-making equipment?
2. What did Bovard want in this case?
3. If it was not illegal to make bongs and roach clips, why did the court determine that this contract should not be enforced?

Unlicensed Practitioner Cannot Collect Fee

Venturi & Company v. Pacific Malibu Development Corp.

172 Cal.App.4th 1417 (Calif. Ct. App. 2009)

Rubin, J.

In June 2003, plaintiff Venturi & Company LLC and defendant Pacific Malibu Development Corp. entered into a contract involving development of a high-end resort on undeveloped property on the Bahamian island of Little Exuma. Under the contract, plaintiff agreed to serve as a financial advisor and find financing for the Little Exuma project....[P]laintiff was entitled to some payment under the contract even if plaintiff did not secure financing for the project [called a success fee].

After signing the contract, plaintiff contacted more than 60 potential sources of financing for the project....[I]n the end, defendants did not receive financing from any source that plaintiff had identified.

Defendants terminated the contract in January 2005. Two months earlier, however, defendants had signed a [financing agreement] with the Talisker Group. Plaintiff was not involved in defendants' negotiations with the Talisker Group....Nevertheless, plaintiff claimed the contract's provision for a success fee entitled plaintiff to compensation following the [agreement]. When defendants refused to pay plaintiff's fee, plaintiff sued defendants for the fee and for the reasonable value of plaintiff's services.

Defendants moved for summary judgment. They argued plaintiff had provided the services of a real estate broker by soliciting financing for the Little Exuma project yet did not have a broker's license. Thus, defendants asserted...the Business and Professions Code barred plaintiff from receiving any compensation as an unlicensed broker....Plaintiff opposed summary judgment. It argued that one of its managing principals, Jane Venturi, had a real estate sales license and was employed by a real estate broker (whom plaintiff did not identify) when defendants had signed their term sheet with the Talisker Group, the document that triggered plaintiff's right to a fee.

The court entered summary judgment for defendants. The court found plaintiff had acted as a real estate broker when working on the Little Exuma project. The court pointed, however, to plaintiff's lack of evidence that Jane Venturi's unnamed broker had employed or authorized her to work on the project....[Summary judgment was issued in favor of defendants, denying plaintiff any recovery.] This appeal followed.

The court correctly ruled plaintiff could not receive compensation for providing real estate broker services to defendants because

plaintiff was not a licensed broker. (Section 11136 [broker's license required to collect compensation for broker services].) But decisions such as *Lindenstadt* [Citation] establish that the court erred in denying plaintiff compensation to the extent plaintiff's services were not those of a real estate broker. In *Lindenstadt,* the parties entered into 25 to 30 written agreements in which the plaintiff promised to help the defendant find businesses for possible acquisition. After the plaintiff found a number of such businesses, the defendant refused to compensate the plaintiff. The defendant cited the plaintiff's performance of broker's services without a license as justifying its refusal to pay. On appeal, the appellate court rejected the defendant's sweeping contention that the plaintiff's unlicensed services for *some* business opportunities meant the plaintiff could not receive compensation for *any* business opportunity. Rather, the appellate court directed the trial court to examine individually each business opportunity to determine whether the plaintiff acted as an unlicensed broker for that transaction or instead provided only services for which it did not need a broker's license.

Likewise here, the contract called for plaintiff to provide a range of services, some apparently requiring a broker's license, others seemingly not. Moreover, and more to the point, plaintiff denied having been involved in arranging, let alone negotiating, defendants' placement of Securities with the Talisker Group for which plaintiff claimed a "success fee" under the contract's provision awarding it a fee even if it had no role in procuring the financing. Thus, triable issues existed involving the extent to which plaintiff provided either unlicensed broker services or, alternatively, non-broker services for which it did not need a license. (Accord: [Citation] [severability allowed partial enforcement of personal manager employment contract when license required for some, but not all, services rendered under the contract].)

[T]he contract here...envisioned plaintiff directing its efforts toward many potential sources of financing. As to some of those sources, plaintiff may have crossed the line into performing broker services. But for other sources, plaintiff may have provided only financial and marketing advice for which it did not need a broker's license. (See, e.g. [Citation] [statute barring unlicensed contractor from receiving fees for some services did not prohibit recovery for work not within scope of licensing statute].) And finally, as to the Talisker Group, plaintiff may have provided even less assistance than financial and marketing advice, given that plaintiff denied involvement with the group. Whether plaintiff crossed the line into providing broker services is thus a triable issue of fact that we cannot resolve on summary judgment.

...Plaintiff...did not have a broker's license, and therefore was not entitled to compensation for broker's services. Plaintiff contends it was properly licensed because one of its managers, Jane Venturi, obtained a real estate sales license in February 2004. Thus, she, and plaintiff claims by extension itself, were licensed when defendants purportedly breached the contract by refusing to pay plaintiff months later for the Talisker Group placement. Jane Venturi's sales license was not, however, sufficient; only a licensed broker may provide broker services. A sales license does not permit its holder to represent another unless the salesperson acts under a broker's authority.

The judgment for defendants is vacated, and the trial court is directed to enter a new order denying defendants' motion for summary judgment....

CASE QUESTIONS

1. Why did the plaintiff think it should be entitled to full recovery under the contract, including for services rendered as a real estate broker? Why did the court deny that?
2. Even if the plaintiff were not a real estate broker, why would that mean it could not recover for real estate services provided to the defendant?
3. The appeals court remanded the case; what did it suggest the plaintiff should recover on retrial?

Unconscionability

Williams v. Walker-Thomas Furniture Co.

350 F.2d 445 (D.C. Ct. App. 1965)

Wright, J.

Appellee, Walker-Thomas Furniture Company, operates a retail furniture store in the District of Columbia. During the period from 1957 to 1962 each appellant in these cases purchased a number of household items from Walker-Thomas, for which payment was to be made in installments. The terms of each purchase were contained in a printed form contract which set forth the value of the purchased item and purported to lease the item to appellant for a stipulated monthly rent payment. The contract then provided,

in substance, that title would remain in Walker-Thomas until the total of all the monthly payments made equaled the stated value of the item, at which time appellants could take title. In the event of a default in the payment of any monthly installment, Walker-Thomas could repossess the item.

The contract further provided that 'the amount of each periodical installment payment to be made by (purchaser) to the Company under this present lease shall be inclusive of and not in addition to the amount of each installment payment to be made by (purchaser) under such prior leases, bills or accounts; and all payments now and hereafter made by (purchaser) shall be credited pro rata on all outstanding leases, bills and accounts due the Company by (purchaser) at the time each such payment is made.' The effect of this rather obscure provision was to keep a balance due on every item purchased until the balance due on all items, whenever purchased, was liquidated. As a result, the debt incurred at the time of purchase of each item was secured by the right to repossess all the items previously purchased by the same purchaser, and each new item purchased automatically became subject to a security interest arising out of the previous dealings.

On May 12, 1962, appellant Thorne purchased an item described as a daveno, three tables, and two lamps, having total stated value of $391.11 [about $2,800 in 2011 dollars]. Shortly thereafter, he defaulted on his monthly payments and appellee sought to replevy [repossess] all the items purchased since the first transaction in 1958. Similarly, on April 17, 1962, appellant Williams bought a stereo set of stated value of $514.95 [about $3,600 in 2011 dollars]. She too defaulted shortly thereafter, and appellee sought to replevy all the items purchased since December, 1957. The Court of General Sessions granted judgment for appellee. The District of Columbia Court of Appeals affirmed, and we granted appellants' motion for leave to appeal to this court.

Appellants' principal contention, rejected by both the trial and the appellate courts below, is that these contracts, or at least some of them, are unconscionable and, hence, not enforceable. [In its opinion the lower court said:]

The record reveals that prior to the last purchase appellant had reduced the balance in her account to $164. The last purchase, a stereo set, raised the balance due to $678. Significantly, at the time of this and the preceding purchases, appellee was aware of appellant's financial position. The reverse side of the stereo contract listed the name of appellant's social worker and her $218 monthly stipend from the government. Nevertheless, with full knowledge that appellant had to feed, clothe and support both herself and seven children on this amount, appellee sold her a $514 stereo set.

We cannot condemn too strongly appellee's conduct. It raises serious questions of sharp practice and irresponsible business dealings. A review of the legislation in the District of Columbia affecting retail sales and the pertinent decisions of the highest court in this jurisdiction disclose, however, no ground upon which this court can declare the contracts in question contrary to public policy. We note that were the Maryland Retail Installment Sales Act...or its equivalent, in force in the District of Columbia, we could grant appellant appropriate relief. We think Congress should consider corrective legislation to protect the public from such exploitive contracts as were utilized in the case at bar.

We do not agree that the court lacked the power to refuse enforcement to contracts found to be unconscionable. In other jurisdictions, it has been held as a matter of common law that unconscionable contracts are not enforceable. While no decision of this court so holding has been found, the notion that an unconscionable bargain should not be given full enforcement is by no means novel....

Since we have never adopted or rejected such a rule, the question here presented is actually one of first impression....[W]e hold that where the element of unconscionability is present at the time a contract is made, the contract should not be enforced.

Unconscionability has generally been recognized to include an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party. Whether a meaningful choice is present in a particular case can only be determined by consideration of all the circumstances surrounding the transaction. In many cases the meaningfulness of the choice is negated by a gross inequality of bargaining power. The manner in which the contract was entered is also relevant to this consideration. Did each party to the contract, considering his obvious education or lack of it, have a reasonable opportunity to understand the terms of the contract, or were the important terms hidden in a maze of fine print and minimized by deceptive sales practices? Ordinarily, one who signs an agreement without full knowledge of its terms might be held to assume the risk that he has entered a one-sided bargain. But when a party of little bargaining power, and hence little real choice, signs a commercially unreasonable contract with little or no knowledge of its terms, it is hardly likely that his consent, or even an objective manifestation of his consent, was ever given to all the terms. In such a case the usual rule that the terms of the agreement are not to be questioned should be abandoned and the court should consider whether the terms of the contract are so unfair that enforcement should be withheld....

In determining reasonableness or fairness, the primary concern must be with the terms of the contract considered in light of the circumstances existing when the contract was made. The test is not simple, nor can it be mechanically applied. The terms are

to be considered 'in the light of the general commercial background and the commercial needs of the particular trade or case.' Corbin suggests the test as being whether the terms are 'so extreme as to appear unconscionable according to the mores and business practices of the time and place.' We think this formulation correctly states the test to be applied in those cases where no meaningful choice was exercised upon entering the contract. So ordered.

Danaher, J. (dissenting):

[The lower] court...made no finding that there had actually been sharp practice. Rather the appellant seems to have known precisely where she stood.

There are many aspects of public policy here involved. What is a luxury to some may seem an outright necessity to others. Is public oversight to be required of the expenditures of relief funds? A washing machine, e.g., in the hands of a relief client might become a fruitful source of income. Many relief clients may well need credit, and certain business establishments will take long chances on the sale of items, expecting their pricing policies will afford a degree of protection commensurate with the risk. Perhaps a remedy when necessary will be found within the provisions of the D.C. "Loan Shark" law, [Citation].

I mention such matters only to emphasize the desirability of a cautious approach to any such problem, particularly since the law for so long has allowed parties such great latitude in making their own contracts. I dare say there must annually be thousands upon thousands of installment credit transactions in this jurisdiction, and one can only speculate as to the effect the decision in these cases will have.

CASE QUESTIONS

1. Did the court here say that cross-collateral contracts are necessarily unconscionable?
2. Why is it relevant that the plaintiff had seven children and was on welfare?
3. Why did the defendant have a cross-collateral clause in the contract? What would happen if no such clauses were allowed?
4. What are the elements of unconscionability that the court articulates?

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11.6: Summary and Exercises

Summary

In general, illegal contracts are unenforceable. The courts must grapple with two types of illegalities: (1) statutory violations and (2) violations of public policy not expressly declared unlawful by statute. The former include gambling contracts, contracts with unlicensed professionals, and Sunday contracts.

Contracts that violate public policy include many types of covenants not to compete. No general rule for determining their legality can be given, except to say that the more rigid their restrictions against working or competing, the less likely they will withstand judicial scrutiny. Other types of agreements that may violate public policy and hence are unenforceable include provisions that waive tort liability and contracts that interfere with family relationships.

The exceptions to the rule that illegal agreements will not be enforced and that courts leave the parties where they are generally involve situations where the hands-off approach would lead to an unfair result: where the parties are not equally at fault, where one is excusably ignorant or withdraws before performance, or where one is protected by a statute. A court may sometimes divide a contract, enforcing the legal part and not the illegal part.

EXERCISES

1. Henrioulle was an unemployed widower with two children who received public assistance from the Marin County (California) Department of Social Services. There was a shortage of housing for low-income residents in Marin County. He entered into a lease agreement on a printed form by which the landlord disclaimed any liability for any injury sustained by the tenants anywhere on the property. Henrioulle fractured his wrist when he tripped on a rock on the common stairs in the apartment building. The landlord had been having a hard time keeping the area clean. Is the disclaimer valid? Explain.
2. Albert Bennett, an amateur cyclist, entered a bicycle race sponsored by the United States Cycling Federation. He signed a release exculpating the federation for liability: “I further understand that serious accidents occasionally occur during bicycle racing and that participants in bicycle racing occasionally sustain mortal or serious personal injuries, and/or property damage, as a consequence thereof. Knowing the risks of bicycle racing, nevertheless I hereby agree to assume those risks and to release and hold harmless all the persons or entities mentioned above who (through negligence or carelessness) might otherwise be liable to me (or my heirs or assigns) for damages.”

   During the race, Bennett was hit by an automobile that had been allowed on the otherwise blocked-off street by agents of the defendant. Bennett sued; the trial court dismissed the case on summary judgment. Bennett appealed. What was the decision on appeal?

3. Ramses owned an industrial supply business. He contracted to sell the business to Tut. Clause VI of their Agreement of Sale provided as follows: “In further consideration for the purchase, Ramses agrees that he shall not compete, either directly or indirectly, in the same business as is conducted by the corporation in its established territory.”

   Two months after the sale, Ramses opened a competing business across the street from the business now owned by Tut, who brought suit, asking the court to close Ramses’s business on the basis of Clause VI. What should the court decide? Why?

4. After taking a business law class at State U, Elke entered into a contract to sell her business law book to a classmate, Matthew, for $45. As part of the same contract, she agreed to prepare a will for Matthew’s mother for an additional $110. Elke prepared the will and sent the book to Matthew, but he refused to pay her. Is she entitled to any payment? Explain.
5. Elmo, a door-to-door salesman, entered into a contract to sell the Wilson family $320 worth of household products on credit. The Wilsons later learned that Elmo had failed to purchase a city license to make door-to-door sales and refused to pay him. May Elmo collect from the Wilsons? Why?
6. Gardner purchased from Singer a sewing machine ($700) and three vacuums (about $250 each), one after the other, on Singer’s “1 to 36 month plan.” Gardner defaulted after paying a total of $400 on account, and Singer sued to repossess all the purchases. Gardner defended by claiming the purchase plan was unconscionable and pointed to the *Williams* case (Section 12.5.3 "Unconscionability") as controlling law (that cross-collateral contracts are unconscionable). The trial court ruled for Gardner; Singer appealed. What was the result on appeal?

7. Blubaugh leased a large farm combine from John Deere Leasing by signing an agreement printed on very lightweight paper. The back side of the form was "written in such fine, light print as to be nearly illegible....The court was required to use a magnifying glass." And the wording was "unreasonably complex," but it contained terms much in John Deere's favor. When Blubaugh defaulted, John Deere repossessed the combine, sold it for more than he had paid, and sued him for additional sums in accordance with the default clauses on the back side of the lease. Blubaugh defended by asserting the clauses were unconscionable. Is this a case of procedural, substantive, or no unconscionability? Decide.
8. Sara Hohe, a fifteen-year-old junior at Mission Bay High School in San Diego, was injured during a campus hypnotism show sponsored by the PTSA as a fund-raiser for the senior class. Hypnotism shows had been held annually since 1980, and Sara had seen the previous year's show. She was selected at random from a group of many volunteers. Her participation in the "Magic of the Mind Show" was conditioned on signing two release forms. Hohe's father signed a form entitled "Mission Bay High School PTSA Presents Dr. Karl Santo." Hohe and her father both signed a form titled "Karl Santo Hypnotist," releasing Santo and the school district from all liability. During the course of the show, while apparently hypnotized, Hohe slid from her chair and also fell to the floor about six times and was injured. She, through her father, then sued the school district. The Hohes claimed the release was contrary to public policy; the trial court dismissed the suit on summary judgment. Was the release contrary to public policy? Decide.
9. In 1963 the Southern Railway Company was disturbed by an order issued by the Interstate Commerce Commission, a federal agency, which would adversely affect the firm's profit by some $13 million [about $90 million in 2011 dollars]. Southern hired a lawyer, Robert Troutman, who was a friend of President John F. Kennedy, to lobby the president that the latter might convince the attorney general, Robert Kennedy, to back Southern's position in a lawsuit against the ICC. It worked; Southern won. Southern then refused to pay Troutman's bill in the amount of $200,000 [about $14 million in 2011 dollars] and moved for summary judgment dismissing Troutman's claim, asserting—among other things—that contracts whereby one person is hired to use his influence with a public official are illegal bargains. Should summary judgment issue? Decide.
10. Buyer, representing himself to be experienced in timber negotiations, contracted to buy the timber on Seller's land. The first $11,500 would go to Buyer, the next $2,000 would go to Seller, and the rest would be divided fifty-fifty after costs of removal of the timber. Buyer said the timber would be worth $18,000–$20,000. When Seller discovered the timber was in fact worth more than $50,000, he sued, claiming the contract was unconscionable. How should the court rule?

SELF-TEST QUESTIONS

1. Gambling contracts are
    1. always unenforceable
    2. enforceable if written
    3. in effect enforceable in certain situations involving the sale of securities
    4. always enforceable when made with insurance companies
2. In State X, plumbers must purchase a license but do not have to pass an examination. This is an example of
    1. a regulatory license
    2. a revenue license
    3. both a and b
    4. neither a nor b
3. A contract to pay a lobbyist to influence a public official is generally illegal.
    1. true
    2. false
4. Exculpatory clauses are sometimes enforceable when they relieve someone from liability for
    1. an intentional act
    2. recklessness
    3. negligence
    4. all of the above
5. An employee's promise not to compete with the employer after leaving the company
    1. is never enforceable because it restrains trade
    2. is always enforceable if in writing
    3. is always enforceable
    4. is enforceable if related to the employer's property interests

SELF-TEST AnswerS

1. c
2. b

3. b
4. c
5. d

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12: THE WRITING REQUIREMENT AND INTERPRETATION OF AGREEMENTS

Learning Objectives

After reading this chapter, you should understand the following:

- What kinds of contracts must be evidenced by some writing under the Statute of Frauds, what the exceptions to the requirements are, and what satisfies a writing requirement
- What effect prior or contemporaneous "side" agreements have on a written contract
- How a contract is to be interpreted if its meaning is disputed

In four chapters, we have focused on the question of whether the parties created a valid contract and have examined the requirements of (1) agreement (offer and acceptance), (2) real consent (free will, knowledge, and capacity), (3) consideration, and (4) legality. Assuming that these requirements have been met, we now turn to the form and meaning of the contract itself. Does the contract have to be in a written form, and—if there is a dispute—what does the contract mean?

12.1: The Statute of Frauds

12.2: The Parol Evidence Rule

12.3: Interpretation of Agreements- Practicalities versus Legalities

12.4: Cases

12.5: Summary and Exercises

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12.1: The Statute of Frauds

LEARNING OBJECTIVES

1. Know which contracts are required to be evidenced by some writing to be enforceable.
2. Understand the exceptions to that requirement.
3. Recognize what the writing requirement means.
4. Understand the effect of noncompliance with the Statute of Frauds.

Overview of the Statute of Frauds

General Rule: Oral Contracts Are Valid

As a general rule, contracts do **not** need to be in writing to be enforceable. A handshake deal or even a spoken promise, if it includes offer, acceptance, and consideration, can be just as binding as a written agreement. For example, an oral agreement to pay a high-fashion model $2 million to pose for a photo shoot is legally enforceable, even if nothing was written down or signed. The law recognizes that mutual promises—whether written or spoken—create real obligations.

However, centuries of experience have shown that some types of agreements are too important, too complex, or too prone to misunderstanding to rely on memory alone. In the 17th century, the English Parliament passed a law known as the **Statute of Frauds (1677)** to address this concern. The goal was to prevent fraud, perjury, and unreliable claims by requiring certain categories of contracts to be memorialized in writing. Most modern U.S. states have adopted their own versions of this statute.

The Statute of Frauds does **not** mean that oral contracts are invalid. Instead, it creates a **limited exception**: certain types of agreements are unenforceable unless they are in writing and signed by the party being charged. These typically include contracts involving land, contracts that cannot be performed within one year, promises to answer for another's debt, and contracts for the sale of goods above a certain value (under the Uniform Commercial Code, usually $500 or more).

The policy behind the Statute of Frauds is to provide clarity and evidence in situations where disputes are most likely to arise. Written contracts reduce the risk of false claims, help courts interpret the parties' intent, and give both sides a reliable record of their obligations.

Historical Background

The Statute of Frauds was first enacted in England in 1677 under the formal name *"An Act for the Prevention of Frauds and Perjuries."* Its goal was to prevent fraudulent claims that a contract existed when, in fact, no agreement had ever been made.

The statute required that certain categories of contracts be **evidenced by a writing signed by the party to be bound.** This was not necessarily a formal contract; even a note, memorandum, or letter could suffice.

Purpose of the Statute of Frauds

The law serves two main purposes:

1. **Evidentiary Function:** It provides reliable proof that a contract actually exists in important or complex transactions.
2. **Cautionary Function:** It encourages parties to treat certain agreements as tentative until they are put into writing, thus avoiding rash or careless commitments.

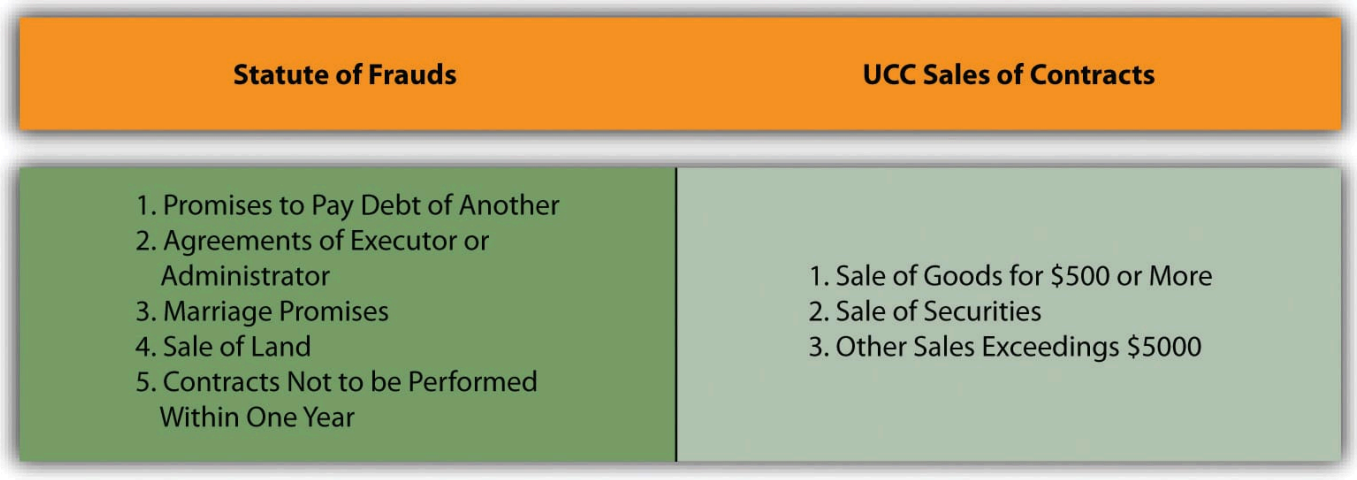
The statute is not primarily about "fraud" as we typically think of it (e.g., deception), but about preventing fraud in the sense of someone fabricating the existence of a contract.

Categories of Contracts Covered

Under the traditional English statute, the following types of contracts had to be in writing:

1. **Executor's Promise** – A promise to pay estate debts from one's own funds.
2. **Suretyship (Collateral Promise)** – A promise to answer for the debt or default of another person.
3. **Marriage Contracts** – Promises made in consideration of marriage.
4. **Contracts for the Sale of Land** – Including leases, transfers, or any interest in land.
5. **Contracts Not Performable Within One Year** – Agreements that cannot be completed within one year from the date of making.
6. **Contracts for the Sale of Goods Over a Certain Value** – Originally £10 in England; now governed by the **UCC**, which generally requires a writing for sales of goods priced at $500 or more (UCC § 2-201).

Figure 13.1 Contracts Required to Be in Writing



However ancient, the Statute of Frauds is alive and well in the United States. Today it is used as a technical defense in many contract actions, often with unfair results: it can be used by a person to wriggle out of an otherwise perfectly fine oral contract (it is said then to be used "as a sword instead of a shield"). Consequently, courts interpret the law strictly and over the years have enunciated a host of exceptions—making what appears to be simple quite complex. Indeed, after more than half a century of serious scholarly criticism, the British Parliament repealed most of the statute in 1954. As early as 1885, a British judge noted that "in the vast majority of cases [the statute's] operation is simply to enable a man to break a promise with impunity because he did not write it down with sufficient formality." A proponent of the repeal said on the floor of the House of Commons that "future students of law will, I hope, have their labours lightened by the passage of this measure." In the United States, students have no such reprieve from the Statute of Frauds, to which we now turn for examination.

Types of Contracts Required in Writing and the Exceptions

Agreements of Executor or Administrator

Another category of promises that fall under the **Statute of Frauds** involves agreements made by executors or administrators of estates. The **general rule** is that if an executor or administrator promises to pay the debt of the deceased **personally**—that is, out of their own funds rather than from the assets of the estate—the promise must be **in writing** to be enforceable.

This provision is closely related to the suretyship rule. In both situations, the promisor is agreeing to be secondarily liable for the obligation of another—the executor for the deceased person's obligations, or a guarantor for the debts of a living person.

Preexisting Obligation Requirement

The rule applies only when there was an obligation in existence **before the decedent's death.**

- **Example 1 – New Obligation (Not Within Statute):** Suppose an executor arranges for the funeral of the deceased and personally promises to pay the bill if the estate cannot. This oral promise is enforceable even if not in writing, because the obligation for funeral services arose after death and was not the decedent's preexisting duty.
- **Example 2 – Preexisting Obligation (Within Statute):** Suppose the decedent had signed a promissory note before death, obligating the estate to pay a creditor. If the executor personally guarantees payment of that note, the promise must be in writing to be enforceable, since it is a collateral promise to answer for an obligation already owed by the deceased.

Promises to Pay the Debt of Another

One category of contracts that falls within the **Statute of Frauds** is the promise to pay the debt or perform the obligation of another person. In general, these promises must be evidenced by a **writing signed by the party to be charged** in order to be enforceable.

Collateral vs. Direct Promises

The statute applies only to **collateral promises**, also called **suretyship** or **guaranty agreements**. A collateral promise is one where the guarantor agrees to step in **only if the primary obligor defaults**.

- **Direct Promise (Not within Statute):**
  If A and B both promise to pay C directly, each is primarily liable. This is not a collateral promise, and it need not be in writing.

- **Collateral Promise (Within Statute):**
  If B promises C, "I will pay if A does not," then B is acting as a surety. This is a secondary obligation that depends on A's default. Such a promise must be in writing to be enforceable.

Example: Suretyship in Practice

Suppose Lydia wants to purchase a fur coat on credit from Miss Juliette's Fine Furs, but Juliette doubts Lydia's creditworthiness. Lydia's friend Jessica promises Juliette, "If you extend Lydia credit, I will pay the balance if Lydia does not." Jessica here is a **surety**, making a collateral promise. Because this is a promise to pay the debt of another, the Statute of Frauds requires that Jessica's promise be in writing.

By contrast, if Jessica calls the store and says, "Send Lydia the coat, and I will pay for it," this is a **direct promise**, not a suretyship. Jessica is primarily liable, and the agreement is enforceable even if oral.

Importantly, the "debt" does not have to be monetary. If Lydia agreed to work as a cashier in exchange for the coat, Jessica could act as surety by promising to work in Lydia's place if Lydia failed to appear. This too would fall under the Statute of Frauds, requiring a writing.

The Main Purpose Doctrine

There is a major exception to the writing requirement: the **main purpose doctrine** (sometimes called the **leading object rule**). If the guarantor's **primary purpose** in making the promise is to advance their **own economic interest**, then the oral promise is enforceable, even though it is a collateral obligation.

Example 1 – Personal Advantage: If Jessica's real motive for guaranteeing Lydia's coat purchase is that she wants the coat for herself, her oral guarantee would be binding, since her main purpose is her own benefit.

Example 2 – Business Advantage: In *Stuart Studio, Inc. v. National School of Heavy Equipment, Inc.* (N.C. 1975), the chairman of a company orally guaranteed payment to a printer so that critical catalogues could be printed. Because his main purpose was to protect his investment in the company, the court held the oral promise enforceable under the main purpose doctrine.

Example 3 – Creditor Protection: In another case (Wilson Floors), a bank was held to an oral agreement where its primary interest was protecting its own financial exposure. Again, the guarantor's self-interest removed the agreement from the Statute of Frauds.

The Marriage Provision

The **general rule** is that if a promise to marry, or marriage itself, is tied to the exchange of some **consideration** (property, money, or other benefits), then the Statute of Frauds requires that part of the agreement to be **in writing** in order to be enforceable. This is codified in the **Restatement (Second) of Contracts, Section 125.**

Mutual Promises to Marry

Mutual promises to marry are **not** within the Statute of Frauds. For example, if John and Sally exchange promises to marry, their oral agreement would not be invalid for lack of a written record. Of course, courts today will not compel specific performance of such promises, since forcing individuals into marriage against their will would be contrary to public policy. The key point is that the Statute of Frauds does not apply to **simple mutual promises of marriage.**

Promises with Additional Consideration

When a marriage promise is tied to additional consideration, a writing is required.

- **Example 1 – Property Transfer:** If John tells Sally, "If you marry me, I will deed to you my property in the Catskill Mountains," then the promise to transfer the property must be evidenced by a writing. Otherwise, Sally cannot enforce the property transfer if John later denies it.
- **Example 2 – Third-Party Promise:** If John's father says, "If you marry Sally and settle down, I will give you $1 million," and John marries Sally in reliance on that promise, the father's promise is unenforceable unless in writing.

In both examples, the marriage itself is not the issue; it is the **property or monetary promise tied to the marriage** that triggers the Statute of Frauds.

Prenuptial and Postnuptial Agreements

Wealthy couples, and increasingly couples in general, often create written agreements to satisfy the Statute of Frauds and to clarify how property will be handled in the event of divorce or death.

- **Prenuptial agreements ("prenups")**: Contracts made before marriage, setting terms for property rights, spousal support, or inheritance.
- **Postnuptial agreements ("postnups")**: Contracts made after marriage but serving a similar function.

Because these agreements typically involve significant property rights, they must be in writing and are often subject to heightened judicial scrutiny for fairness and voluntariness.

Contracts Affecting an Interest in Real Estate

General Rule

Under the **Statute of Frauds**, virtually all contracts involving an interest in **real estate** must be in **writing** to be enforceable. The term *"interest in land"* is broad and covers more than just the sale of a home. It includes:

- The **sale or purchase** of real property (land, homes, buildings).
- The **mortgaging** of real estate.
- The **leasing** of property (with the usual exception for short-term leases of one year or less).
- The transfer of **profits from land** (e.g., rights to harvest crops, mine minerals, or cut timber).
- The creation of **easements** (rights to cross or use land belonging to another).
- The establishment of **restrictive covenants** or agreements regarding property use (such as promises not to build certain

structures).

Because real estate is both valuable and unique, legislatures and courts require written evidence to avoid fraudulent claims and misunderstandings.

Example – Writing Required

If David orally agrees to sell his house to Maria for $300,000 and then refuses to go through with the sale, Maria cannot enforce the oral contract. Since the agreement involves the sale of real estate, it falls squarely within the Statute of Frauds and must be in writing.

The One-Year Rule

General Rule

Under the Statute of Frauds, **any agreement that cannot be performed within one year from the date it is made must be in writing** to be enforceable. The purpose of this requirement is practical: oral agreements made for long-term obligations are prone to dispute because **memories fade, parties die, and evidence disappears.** Written documentation provides clarity and certainty.

It is important to note that the relevant timeframe begins at the **making of the contract**, not the start of performance.

- **Example:** On January 1, a contractor agrees to build a house, beginning June 1, with completion set for February 1 of the following year. Although the construction itself takes only eight months, performance will not be complete until **thirteen months after the contract was made**. This contract falls within the Statute of Frauds and must be in writing.

Exception: The Possibility Test

Courts interpret the one-year rule using what is often called the **"possibility test."** If it is **possible**—even if highly unlikely—for a contract to be fully performed within one year, the agreement is enforceable even if oral.

- **Example 1 – Not Enforceable:** An oral promise to pay $10,000 exactly thirteen months from the date of the contract is unenforceable, because it is impossible for the obligation to be completed within one year.
- **Example 2 – Enforceable:** An oral promise to pay $10,000 "within thirteen months" is enforceable, because payment could occur sooner (e.g., after six months).
- **Example 3 – Lifetime Contracts:** An oral contract for lifetime employment is generally enforceable, since it is possible the employee could die within a year, completing the contract.

This broad reading reflects the courts' reluctance to invalidate agreements based solely on the Statute of Frauds. Judges often look for ways to interpret contracts as **capable of performance within a year** to avoid harsh results.

Under the UCC

General Rule

Under **UCC § 2-201**, contracts for the **sale of goods priced at $500 or more** must be **evidenced by a writing** to be enforceable. A "writing" does not need to be a formal contract—it can be a signed memorandum, invoice, purchase order, or even an email—so long as it shows that a contract for sale exists and specifies the quantity of goods.

By contrast, oral agreements for the sale of goods valued at **less than $500** are fully enforceable without exception.

Examples

- **Enforceable Oral Contract:** Bob agrees to sell Susan his used guitar for $400. No writing is needed; the agreement is

enforceable.
- **Writing Required:** Susan agrees to buy a piano from Bob for $1,200. If Susan later denies the agreement, Bob cannot enforce it unless there is some writing signed by Susan that shows the sale and the quantity.

Key Features of the UCC Rule

- The **writing requirement** is much less formal than at common law. Only the **quantity term** must appear in the writing, and the writing must be signed by the party to be charged.
- Other terms—such as price, delivery, or payment—can be supplied by the UCC's default rules if omitted.

Exceptions to the Writing Requirement

Even if the contract involves goods worth $500 or more, the UCC recognizes several **important exceptions** where an oral contract will still be enforceable:

1. **Specially Manufactured Goods** – If goods are custom-made for the buyer and unsuitable for resale, an oral agreement is enforceable once the seller has substantially begun performance.
   - *Example:* A manufacturer begins producing 500 jerseys with a high school team's logo. Even if no writing exists, the school must honor the oral contract.
2. **Admissions in Court** – If a party admits in legal proceedings that an oral contract was made, the contract is enforceable up to the quantity admitted.
3. **Partial Performance** – If payment has been made and accepted, or goods have been delivered and accepted, the oral contract is enforceable to that extent.
   - *Example:* If Susan pays $600 toward a $1,200 piano and Bob accepts the payment, the oral contract is enforceable at least to the extent of the $600.
4. **Merchant's Confirmatory Memo Rule** – Between merchants, if one party sends a written confirmation of the oral agreement and the other party does not object within 10 days, the writing satisfies the Statute of Frauds for both parties.

Policy Rationale

The UCC's $500 threshold reflects a balance between the need for certainty in higher-value transactions and the practicality of allowing oral contracts for everyday purchases. The exceptions recognize that reliance, custom manufacturing, or partial performance may provide sufficient evidence of an agreement, reducing the risk of fraud.

KEY TAKEAWAY

The Statute of Frauds, an ancient legislative intrusion into common-law contracts, requires that certain contracts be evidenced by some writing, signed by the party to be bound, to be enforceable. Among those affected by the statute are contracts for an interest in real estate, contracts that by their terms cannot be performed within one year, contracts whereby one person agrees to pay the debt of another, contracts involving the exchange of consideration upon promise to marry (except mutual promises to marry), and, under the UCC, contracts in an amount greater than $500. For each contract affected by the statute, there are various exceptions intended to prevent the statute from being used to avoid oral contracts when it is very likely such were in fact made.

The writing need not be a contract; anything in writing, signed by the person to be bound, showing adequate contractual intention will take the matter out of the statute and allow a party to attempt to show the existence of the oral contract.

There may be relief under restitution or promissory estoppel. Contracts affected by the statute can usually be orally rescinded. Any contract can be modified or rescinded; if the new oral contract as modified does not fall within the statute, the statute does not apply.

EXERCISES

1. What is the purpose of the Statute of Frauds?
2. What common-law contracts are affected by it, and what are the exceptions?
3. How does the UCC deal with the Statute of Frauds?

4. How is the requirement of the statute satisfied?
5. Contracts can always be modified. How does the Statute of Frauds play with contract modification?

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12.2: The Parol Evidence Rule

LEARNING OBJECTIVES

1. Understand the purpose and operation of the parol evidence rule, including when it applies and when it does not.
2. Know how the Uniform Commercial Code (UCC) deals with evidence to show a contract's meaning.

The Definition and Purpose of the Rule

Imagine this scenario:
Maria agrees to buy an antique dining table from David for $5,000. They negotiate for weeks, and at one point David says, "I'll also include six antique chairs for free." But when they finally sign the written contract, it only states: *"Seller agrees to sell Buyer one antique dining table for $5,000."* After the contract is signed, Maria demands the six chairs. David refuses, pointing to the contract: "The chairs aren't in writing." Maria insists she should still get them because David promised.

This dispute illustrates why the **Parol Evidence Rule** exists. The rule governs what kinds of evidence may be introduced in court when interpreting or enforcing a written contract. In essence, once parties put their agreement into a final written document, courts generally will not allow evidence of prior or contemporaneous oral or written promises to contradict, vary, or add to the written terms.

Courts often apply the "**four corners rule**," meaning they will look only at the written contract itself to determine the parties' intent. If the contract appears to be a complete and final statement of the agreement, outside evidence (like Maria's testimony about the chairs) will be excluded. If the contract is ambiguous or clearly incomplete, however, the court may look beyond its four corners.

The Parol Evidence Rule promotes certainty in contracts by:

1. Giving priority to the written contract as the best evidence of the parties' deal.
2. Encouraging parties to reduce their entire agreement to writing.
3. Protecting against unreliable or self-serving testimony about alleged oral promises.
4. Promoting fairness by providing a clear reference point for enforcement.

The Exemptions and Exceptions

Although the Parol Evidence Rule is strict, courts recognize several important exceptions. Returning to our scenario, Maria might succeed if one of these exceptions applies:

1. Clarify Ambiguities

If a contract term is unclear, parol evidence can explain its meaning.

- **Example:** If the contract said "antique dining set" instead of "table," Maria might introduce evidence to show both parties meant "table plus chairs."

2. Show Fraud, Duress, or Mistake

Evidence is admissible to prove the contract was never valid because it was induced by fraud, signed under duress, or contains a mistake.

- **Example:** If David knew Maria believed the chairs were included but deliberately omitted them to deceive her, Maria could introduce evidence of fraud.

3. Prove a Condition Precedent

If the parties agreed the contract would only take effect upon a certain event, evidence of that condition may be admitted.

- **Example:** Suppose Maria and David orally agreed the contract would be binding only if Maria's loan was approved. Evidence of that condition precedent is admissible.

4. Demonstrate Subsequent Modifications

The rule does not bar evidence of agreements made after the contract was signed.

- **Example:** If David later agreed in writing to include the chairs for an additional $500, that later modification is enforceable.

5. Show that the Writing Was Not Intended as a Final Agreement

If the signed contract was only a draft or memorandum, parol evidence can show the parties did not intend it as the final expression of their bargain.

- **Example:** If Maria and David agreed the signed document was just a "placeholder" until the full inventory of items could be listed, oral promises may still be admissible.

6. Trade Usage, Course of Dealing, or Course of Performance (UCC Approach)

The Uniform Commercial Code (UCC) is more flexible than common law. Under UCC § 2-202, evidence of industry custom, prior dealings, or the parties' actual conduct can be introduced to explain or supplement a written contract—even if it looks complete on its face.

- **Course of Dealing:** If Maria had bought antiques from David before, and he always included matching chairs when selling a table, that prior course of dealing could explain her expectation.
- **Usage of Trade:** In the antiques trade, if the phrase "dining set" customarily means "table plus chairs," evidence of that trade usage may clarify the contract.
- **Course of Performance:** If David delivered the table and six chairs, and Maria accepted them without objection for months, that behavior could help courts interpret what the parties meant.

KEY TAKEAWAY

The **Parol Evidence Rule** preserves the integrity of written contracts by excluding prior or contemporaneous oral promises that contradict or vary the written terms. However, the rule is not absolute. Courts admit outside evidence to clarify ambiguities, prove fraud or duress, establish conditions precedent, show later modifications, or interpret terms through trade usage, course of dealing, or course of performance.

In our scenario, unless Maria can show ambiguity, fraud, or trade usage, she will likely be bound by the written contract—one table, no chairs.

EXERCISES

1. What is the purpose of the parol evidence rule?
2. How does it operate to crystallize the intention of the contracting parties?
3. To what kinds of contract issues does the rule not apply?
4. What "help" does the UCC give to fleshing out the parties' contractual understanding?

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12.3: Interpretation of Agreements- Practicalities versus Legalities

LEARNING OBJECTIVES

1. Understand the purpose of contractual interpretation.
2. Know the tools courts use to interpret contracts.
3. Recognize that in everyday life, businesspeople tolerate oral contracts or poorly written ones, but a writing remains useful.

The General Problem and the Purpose of Contractual Interpretation

Imagine this scenario:
Olivia owns a small catering business. She signs a contract with Greenfield Event Center to provide food for 500 guests at a corporate banquet. The contract states: *"Caterer will provide meals and beverages for the event."* But the contract does not specify whether alcohol is included. Olivia assumed "beverages" meant non-alcoholic drinks, while Greenfield believed it meant wine, beer, and cocktails. When the event takes place, Greenfield demands alcohol service, but Olivia refuses, saying that would double her costs.

This dispute highlights the **general problem of contract interpretation**: words that look clear at first glance may carry different meanings depending on context. Justice Oliver Wendell Holmes Jr. expressed it best: *"A word is not a crystal, transparent and unchanged; it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used"* (Towne v. Eisner, 245 U.S. 418, 425 [1917]).

Ambiguities can arise in many ways:

- Careless drafting that leaves out essential details.
- Standard "form contracts" clashing with customized provisions.
- Industry jargon understood by insiders but confusing to outsiders.
- Different assumptions about what is "obvious" (e.g., Olivia thought beverages meant soda, not champagne).

Because of these risks, courts are often asked to interpret contract terms and determine what the parties really intended.

The Basic Rule of Interpretation

Courts generally try to give meaning to the contract based on what the parties intended when they wrote it. If their purpose can be determined from the circumstances or the written terms, courts will weigh that heavily in resolving disputes.

- **Example:** A father promises a bookstore he will guarantee his daughter's textbook purchases "up to $350." He later pays bills totaling $550 before refusing to pay another $150 invoice. A court could interpret his behavior as showing intent to cover all his daughter's necessary books, not just the stated cap.

Returning to Olivia's catering dispute: If evidence shows that Greenfield had always contracted with caterers for full bar service and Olivia knew this, the court might interpret "beverages" to include alcohol. If instead Olivia never provided alcohol in her business and Greenfield knew this, the court might favor her narrower interpretation.

Tools of Interpretation

To uncover intent, courts apply several interpretive tools:

1. **Specific over general** – A specific clause or negotiated term carries more weight than a general form provision.
    - Example: If Olivia's contract included a handwritten note saying "non-alcoholic beverages only," that term would prevail over the general phrase "meals and beverages."

2. **Whole-document reading** – A contract is read as a whole, not clause by clause. Courts avoid isolating a single phrase that contradicts the overall purpose.
3. **Common vs. technical meanings** – Common words are given ordinary meaning; technical terms are given their specialized meaning in the trade.
   - Example: In construction contracts, "board foot" has a precise trade definition that differs from everyday use.
4. **Hierarchy of interpretation** – Courts prefer evidence in this order: express terms → course of performance → course of dealing → usage of trade.
   - Example: If Olivia and Greenfield had previously contracted three times before, and each time alcohol was included, that prior course of dealing would inform interpretation.
5. **Words vs. numbers** – If words and numbers conflict, the words usually control.
6. **Medium of expression** – Handwriting prevails over typing; typing prevails over preprinted forms.
7. **Contra proferentem rule** – Ambiguities are interpreted against the drafter (the party who wrote the contract). If Greenfield drafted the banquet contract, ambiguities about "beverages" would likely be resolved in Olivia's favor.

Why Written Contracts Matter

While oral agreements and handshakes are still common in business, written contracts serve three critical purposes:

1. **Avoid ambiguity** – Writing forces clarity. If Olivia and Greenfield had specified "soft drinks only," the dispute would never arise.
2. **Coordinate responsibilities** – In large organizations, a written contract helps sales, finance, operations, and legal departments understand and allocate responsibilities.
3. **Provide proof** – If a dispute reaches court, the written contract is the best evidence of the parties' agreement.

As business law scholar Stewart Macaulay observed decades ago, many businesspeople prefer to rely on "a man's word" rather than detailed contracts. But that approach often glosses over difficult details until it's too late, forcing courts to resolve disputes that could have been avoided.

KEY TAKEAWAY

Contract interpretation matters because words are not static—they shift in meaning depending on context, assumptions, and industry practices. Courts aim to give effect to the parties' intent, using tools like specific-over-general clauses, trade usage, and course of performance.

Businesspeople may prefer handshake deals, but written contracts reduce ambiguity, allocate responsibilities, and provide essential proof if disputes arise. Olivia's catering scenario illustrates the point: a single ambiguous word—"beverages"—can create costly litigation if not clearly defined at the outset.

EXERCISES

1. Why do courts fairly frequently have to interpret the meaning of contracts?
2. What is the purpose of contractual interpretation?
3. What tools do the courts use in interpreting contracts?
4. What is the social "cost" of insisting upon a written contract in a business setting? What are the benefits of the contract?

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12.4: Cases

The Statute of Frauds' Main Purpose Doctrine

Wilson Floors Co. v. Sciota Park, Ltd., and Unit, Inc.

377 N.E.2d 514 (1978)

Sweeny, J.

In December of 1971, Wilson Floors Company (hereinafter "Wilson") entered into a contract with Unit, Inc. (hereinafter "Unit"), a Texas corporation to furnish and install flooring materials for "The Cliffs" project, a development consisting of new apartments and an office building to be located in Columbus, Ohio. Unit...was the general manager for the project. The Pittsburgh National Bank (hereinafter the bank), as the construction lender for the project, held mortgages on The Cliffs property security for construction loans which the bank had made to Unit.

As the work progressed on the project Unit fell behind in making payments to Wilson for its completed work in the spring of 1973. At that time, the project was approximately two-thirds completed, the first mortgage money of seven million dollars having been fully dispersed by the bank to Unit. Appellant [Wilson] thereupon stopped work in May of 1973 and informed Unit that it would not continue until payments were forthcoming. On May 15, 1973, the bank conducted a meeting with the subcontractors in The Cliffs project, including Wilson.

At the meeting, the bank sought to determine whether it would be beneficial at that stage of the project to lend more money to Unit, foreclose on the mortgage and hire a new contractor to complete the work, or do nothing. Subcontractors were requested to furnish the bank an itemized account of what Unit owed them, and a cost estimate of future services necessary to complete their job contracts. Having reviewed the alternatives, the bank determined that it would be in its best interest to provide additional financing for the project. The bank reasoned that to foreclose on the mortgage and hire a new contractor at this stage of construction would result in higher costs.

There is conflicting testimony in regard to whether the bank made assurances to Wilson at this meeting that it would be paid for all work to be rendered on the project. However, after the May meeting, Wilson, along with the other subcontractors, did return to work.

Payments from Unit again were not forthcoming, resulting in a second work stoppage. The bank then arranged another meeting to be conducted on June 28, 1973.

At this second meeting, there is conflicting testimony concerning the import of the statements made by the bank representative to the subcontractors. The bank representative who spoke at the meeting testified at trial that he had merely advised the subcontractors that adequate funds would be available to complete the job. However, two representatives of Wilson, also in attendance at the meeting, testified that the bank representative had assured Wilson that if it returned to work, it would be paid.

After the meeting, Wilson returned to work and continued to submit its progress billings to Unit for payment. Upon completion of its portion of The Cliffs project, Wilson submitted its final invoice of $15,584.50 to Unit. This amount was adjusted downward to $15,443.06 upon agreement of Unit and Wilson. However, Wilson was not paid this amount.

As a result of nonpayment, Wilson filed suit...against Unit and the bank to recover the $15,443.06 [about $60,700 in 2010 dollars]. On September 26, 1975, Wilson and Unit stipulated that judgment for the sum of $15,365.84, plus interest, be entered against Unit. When Unit failed to satisfy the judgment, appellant proceeded with its action against the bank. [The trial court decided in favor of Wilson, but the intermediate appellate court reversed the trial court decision.]...[The Ohio statute of frauds provides]:

No action shall be brought whereby to charge the defendant, upon a special promise, to answer for the debt, default, or miscarriage of another person...unless the agreement...or some memorandum thereof, is in writing and signed by the party to be charged....

In paragraph one of *Crawford v. Edison* [an 1887 Ohio case], however, this court stated:

When the leading object of the promisor is, not to answer for another, but to subserve some pecuniary or business purpose of his own, involving a benefit to himself...his promise is not within the statute of frauds, although it may be in form a promise to pay the debt of another and its performance may incidentally have the effect of extinguishing that liability....

So long as the promisor undertakes to pay the subcontractor whatever his services are worth irrespective of what he may owe the general contractor and so long as the main purpose of the promisor is to further his own business or pecuniary interest, the promise is enforceable....

The facts in the instant case reflect that the bank made its guarantee to Wilson to subserve its own business interest of reducing costs to complete the project. Clearly, the bank induced Wilson to remain on the job and rely on its credit for future payments. To apply the statute of frauds and hold that the bank had no contractual duty to Wilson despite its oral guarantees would not prevent the wrong which the statute's enactment was to prevent, but would in reality effectuate a wrong.

Therefore, this court affirms the finding of the Court of Common Pleas that the verbal agreement made by the bank is enforceable by Wilson, and reverses the judgment of the Court of Appeals.

CASE QUESTIONS

1. The exception to the Statute of Frauds in issue here is the main purpose doctrine. How does this doctrine relate to the concept of promissory estoppel?
2. What was the main purpose behind the bank's purported promise?

The Statute of Frauds' One-Year Rule

Iacono v. Lyons

16 S.W.3d 92 (Texas Ct. App. 2000)

O'Connor, J.

Mary Iacono, the plaintiff below and appellant here, appeals from a take-nothing summary judgment rendered in favor of Carolyn Lyons, the defendant below and appellee here. We reverse and remand.

The plaintiff [Iacono] and defendant [Lyons] had been friends for almost 35 years. In late 1996, the defendant invited the plaintiff to join her on a trip to Las Vegas, Nevada. There is no dispute that the defendant paid all the expenses for the trip, including providing money for gambling.

The plaintiff contended she was invited to Las Vegas by the defendant because the defendant thought the plaintiff was lucky. Sometime before the trip, the plaintiff had a dream about winning on a Las Vegas slot machine. The plaintiff's dream convinced her to go to Las Vegas, and she accepted the defendant's offer to split "50-50" any gambling winnings.

In February 1997, the plaintiff and defendant went to Las Vegas. They started playing the slot machines at Caesar's Palace. The plaintiff contends that, after losing $47, the defendant wanted to leave to see a show. The plaintiff begged the defendant to stay, and the defendant agreed on the condition that she (the defendant) put the coins into the machines because doing so took the plaintiff too long. (The plaintiff, who suffers from advanced rheumatoid arthritis, was in a wheelchair.) The plaintiff agreed, and took the defendant to a dollar slot machine that looked like the machine in her dream. The machine did not pay on the first try. The plaintiff then said, "Just one more time," and the defendant looked at the plaintiff and said, "This one's for you, Puddin."

The slot machine paid $1,908,064. The defendant refused to share the winnings with the plaintiff, and denied they had an agreement to split any winnings. The defendant told Caesar's Palace she was the sole winner and to pay her all the winnings.

The plaintiff sued the defendant for breach of contract. The defendant moved for summary judgment on the grounds that any oral agreement was unenforceable under the statute of frauds or was voidable for lack of consideration. The trial court rendered summary judgment in favor of the defendant....

[Regarding the "consideration" argument:] The defendant asserted the agreement, if any, was voidable because there was no consideration. The defendant contended the plaintiff's only contribution was the plaintiff's dream of success in Las Vegas and her "luck." The plaintiff asserted the defendant bargained with her to go to Las Vegas in return for intangibles that the defendant

thought the plaintiff offered (good luck and the realization of the dream). The plaintiff said she gave up her right to remain in Houston in return for the agreement to split any winnings. The plaintiff also asserted the agreement was an exchange of promises.

...The plaintiff alleged she promised to share one-half of her winnings with the defendant in exchange for the defendant's promise to share one-half of her winnings with the plaintiff. These promises, if made, represent the respective benefits and detriments, or the bargained for exchange, necessary to satisfy the consideration requirement. *See* [Citation] (when no other consideration is shown, mutual obligations by the parties to the agreement will furnish sufficient consideration to constitute a binding contract)....[Regarding the Statute of Frauds argument:] The defendant asserted the agreement, if any, was unenforceable under the statute of frauds because it could not be performed within one year. There is no dispute that the winnings were to be paid over a period of 20 years....

[The statute] does not apply if the contract, from its terms, could possibly be performed within a year—however improbable performance within one year may be. [Citations] [It bars] only oral contracts that cannot be completed within one year. [Citation] (If the agreement, either by its terms or by the nature of the required acts, cannot be performed within one year, it falls within the statute of frauds and must be in writing).

To determine the applicability of the statute of frauds with indefinite contracts, this Court may use any reasonably clear method of ascertaining the intended length of performance. [Citation] The method is used to determine the parties' intentions at the time of contracting. The fact that the entire performance within one year is not required, or expected, will not bring an agreement within the statute. *See* [Citations].

Assuming without deciding that the parties agreed to share their gambling winnings, such an agreement possibly could have been performed within one year. For example, if the plaintiff and defendant had won $200, they probably would have received all the money in one pay-out and could have split the winnings immediately. Therefore, the defendant was not entitled to summary judgment based on her affirmative defense of the statute of frauds.

We reverse the trial court's judgment and remand for further proceedings.

CASE QUESTIONS

1. The defendant contended there was no consideration to support her alleged promise to split the winnings fifty-fifty. What consideration did the court find here?
2. The defendant contended that the Statute of Frauds' one-year rule prohibited the plaintiff from attempting to prove the existence of the alleged oral contract to split the winnings. What reasoning did the court give here as to why the statute did not apply?
3. After this case, the court remanded the matter to the lower court. What has to happen there before plaintiff gets her money?

The Parol Evidence Rule: Postcontract Modification

Hampden Real Estate, Inc. v. Metropolitan Management Group, Inc.

142 Fed. Appx. 600 (Fed. Ct. App. Pa. 2005)

Cowen, J.

[The court has jurisdiction based on diversity of citizenship.]

Hampden Real Estate sold Metropolitan Management a residential property pursuant to an Agreement of Sale (the "Sale Agreement"). The Sale Agreement provided that the property would be sold for $3.7 million, that Metropolitan would assume Hampden's mortgage on the building, and that Hampden would receive a credit in the amount of $120,549.78—the amount being held in escrow pursuant to the mortgage (the "Escrow Account Credit").

Between the execution of the Sale Agreement and the closing, the parties negotiated certain adjustments to the purchase price to compensate for required repairs. During these negotiations, the parties reviewed a draft and final Settlement Statement (the "Settlement Statement"), prepared by the closing agent, which did not list the Escrow Account Credit among the various debits and credits. A few weeks after the closing, Hampden demanded payment of the Escrow Account Credit.

Following Metropolitan's refusal to pay the Escrow Account Credit, Hampden filed a complaint claiming breach of contract, unjust

enrichment, and conversion. Metropolitan brought counterclaims for breach of contract, unjust enrichment, and fraudulent or negligent misrepresentation. Hampden brought a partial motion for summary judgment as to the breach of contract claim, which was granted and its unjust enrichment and conversion claims were dismissed as moot....

The District Court correctly determined that the threshold issue is the role of the Settlement Statement, "based on both the intent of the parties and the custom and usage of the document." However, the Court refused to consider extrinsic or parol evidence to determine the intent of the parties, reasoning that the parol evidence rule precluded such consideration absent ambiguity in the written contract. We find that the District Court misapplied the rule. The parol evidence rule seeks to preserve the integrity of written agreements by precluding the introduction of contemporaneous or prior declarations to alter the meaning of written agreements. [Citation] The rule does not apply, however, where a party seeks to introduce evidence of subsequent oral modifications. *See* [Citation:] a "written agreement may be modified by a subsequent written or oral agreement and this modification may be shown by writings or by words or by conduct or by all three. In such a situation the parol evidence rule is inapplicable." Here, the parol evidence rule does not preclude testimony regarding the parties' intention to alter the final purchase price by executing a Settlement Statement, after the execution of the Sale Agreement, which omitted the Escrow Account Credit.

The cases cited by Hampden are not to the contrary as each involved the admissibility of prior negotiations to demonstrate misrepresentations made in the inducement of the contract. As example, the court in [Citation], held that "[i]f a party contends that a writing is not an accurate expression of the agreement between the parties, and that certain provisions were omitted therefrom, the parol evidence rule does not apply." (Permitting the introduction of parol evidence to establish that the contract omitted provisions which appellees represented would be included in the writing)....

The District Court further held that the integration clause contained in the written contract supports the conclusion that the Settlement Statement, which mentioned neither the Escrow Account Credit nor that it was amending the Sale Agreement, is not a modification of the Sale Agreement. The Court explained that the outcome might be different if the Settlement Statement mentioned "the escrow credit but provided different details, but as the [Settlement Statement] in this case simply ignored the escrow credit, and both parties agree that there were no oral discussions regarding the escrow credit, the [Settlement Statement] cannot be said to modify the escrow credit provision in the Agreement of Sale." We disagree.

It is well-settled law in Pennsylvania that a "written contract which is not for the sale of goods may be modified orally, even when the contract provides that modifications may only be made in writing." [Citition] "The modification may be accomplished either by words or conduct," [Citation] demonstrating that the parties intended to waive the requirement that amendments be made in writing. [Citation] An oral modification of a written contract must be proven by "clear, precise and convincing evidence." [Citation] Viewing the evidence in the light most favorable to Metropolitan, we find that the District Court erred in concluding that there was insufficient evidence in the record to raise a genuine issue of material fact as to whether the parties intended to orally modify the Sale Agreement. Metropolitan introduced a Settlement Statement which omitted the Escrow Account Credit, while listing all other debits and credits and submitted an affidavit from its President who "reviewed the Draft Settlement Statement and understood that the Escrow Account Credit had been omitted as part of the ongoing negotiations between the parties concerning the amount of the credit to which Metropolitan was entitled" due to the poor condition of the property.

Accordingly, the District Court erred in granting summary judgment in favor of Hampden. At a minimum, there was a triable issue of fact concerning whether the Settlement Statement was intended to modify the prior written Sale Agreement and serve as the final and binding manifestation of the purchase price. Specifically, whether the parties intended to exclude the Escrow Account Credit from the purchase price as part of the negotiations to address Hampden's failure to maintain the property.

[Reversed and remanded.]

CASE QUESTIONS

1. The contract had an integration clause. Why didn't that bar admission of the subsequent oral modification to the contract?
2. What rule of law was the plaintiff relying on in support of its contention that the original agreement should stand?
3. What rule of law was the defendant relying on in support of its contention that the original agreement had been modified?
4. According to the defendant, how had the original agreement been modified, and why?

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12.5: Summary and Exercises

Summary

In an economic system mostly governed by contract, parties may not only make the kinds of deals they wish but may make them in any form they wish—with some significant exceptions. The most significant issue of form in contract law is whether the contract must be written or may be oral and still be enforceable. The question can be answered by paying close attention to the Statute of Frauds and court decisions interpreting it. In general, as we have seen, the following types of contracts must be in writing: interests in real property, promises to pay the debt of another, certain agreements of executors and administrators, performances that cannot be completed within one year, sale of goods for $500 or more, and sale of securities. There are exceptions to all these rules.

Another significant rule that permeates contract law is the parol evidence rule: prior statements, agreements, or promises, whether oral or written, made during the negotiation process are often discharged by a subsequent written agreement. No matter what you were promised before you signed on the dotted line, you are stuck if you sign an integrated agreement without the promise. Again, of course, exceptions lie in wait for the unwary: Is the agreement only partially integrated? Are there grounds to invalidate the entire agreement? Is the contract subject to an oral condition? Is a fact recited in the contract untrue?

Contracts are not always clear and straightforward. Often they are murky and ambiguous. Interpreting them when the parties disagree is for the courts. To aid them in the task, the courts over the years have developed a series of guidelines such as these: Does the agreement have a plain meaning on its face? If there is an ambiguity, against whom should it be construed? Are there usages of trade or courses of dealing or performance that would help explain the terms?

EXERCISES

1. Plaintiff's and Defendant's cars crashed. Plaintiff hired an attorney, who negotiated with Defendant's insurance adjuster. Plaintiff's attorney claimed he and the adjuster reached an oral settlement, but the insurance company refused to honor it and filed for summary judgment, raising the Statute of Frauds' suretyship provision as a defense: a promise by one person (the insurance company here) to pay the debts of another (the insured) must be evidenced by some writing, and there was no writing. Is the defense good? Explain.
2. Plaintiff Irma Kozlowski cohabited with Defendant Thaddeus Kozlowski for fifteen years without marriage. She repeatedly asked him specifically about her financial situation should he predecease her, and he assured her—she said—that he would arrange to provide for her for the rest of her life. She had provided the necessary household services and emotional support to permit him to successfully pursue his business career; she had performed housekeeping, cleaning, and shopping services and had run the household and raised the children, her own as well as his. When they separated and she was "literally forced out of the house," she was sixty-three years old and had no means or wherewithal for survival. When she sued, he raised the Statute of Frauds' one-year rule as a defense. Is the defense good?*Kozlowski v. Kozlowski*, 395 A.2d 913 (N.J. 1978).
3. Carlson purchased a parcel of real estate that was landlocked. Carlson called his neighbor, Peterson, and asked if he could use an abandoned drive on Peterson's property to travel to his (Carlson's) property from the highway. Peterson said, "Sure, anytime." Later the two became engaged in a dispute, and Peterson blocked the drive. May Carlson enforce Peterson's promise that he could use the drive "anytime"? Why?
4. Silverman, who was elderly and somewhat disabled, lived alone on a farm. Silverman called Burch and said, "Burch, if you will move in with me and help me take care of the farm, it will be yours when I die." Burch did as Silverman requested and on Silverman's death two years later, claimed the farm on the basis of their oral agreement, but the estate resisted. Is Burch entitled to the farm? Why?
5. On February 12, Sally was hired to manage a company for a period of one year. She reported for work on February 26 but was fired two weeks later. She sued the owner of the company for breach of their one-year oral contract. May she recover? Why?
6. Baker entered into an oral contract to sell her car to Clyde for $8,600. She delivered the car to Clyde; Clyde inspected it, found no problems, kept it for three days, but then refused to pay and now wants to return the car. Is the contract enforceable? Why?
7. Wayne, a building contractor, built a new house and offered it for sale. A young couple accepted the offer, and the parties entered into an oral agreement covering all the terms of sale. The couple later tried to back out of the agreement. Wayne filed suit, and during the trial, the couple admitted making the contract. Is the contract enforceable? Why?
8. Plaintiff leased commercial space from Defendant for a florist shop. After the lease was signed, Plaintiff learned that the

county code allowed only one freestanding sign on the property, and one was already up, advertising Defendant's business. Plaintiff claimed Defendant breached the lease by not providing them space for a sign; Defendant pointed to the lease, paragraph 16 of which provided that "Tenant shall not erect or install any sign...without written consent of the Landlord." But Plaintiff claimed Defendant said during negotiations he could have a sign, evidence Defendant objected to based on the parol evidence rule. Defendant admitted that during negotiations he told Plaintiff that despite paragraph 16, he could have a sign (but not freestanding); that despite language in the lease requiring renovation plans to be in writing, they did not have to be. Defendant also testified that the written form lease he used was not drafted specifically for this property, and that although the lease required attachments of exhibits, there were no attachments. Is Plaintiff barred by the parol evidence rule from showing that Defendant said he could have a freestanding sign?

9. On March 1, 2010, Milton talked to Harriet and, as Harriet claimed, said, "I will hire you as sales manager for one year at a salary of $57,000. You start next Monday, March 8." Harriet agreed. Four months later Milton discharged Harriet and she sued, claiming breach of employment contract. Is the alleged contract enforceable?
10. Al Booth's Inc. sued Boyd-Scarp (a contractor) and James Rathmann for nonpayment following delivery of various appliances to Rathmann's new home being built by Boyd-Scarp. Booth's was aware that Boyd-Scarp was having financial problems and allegedly contacted Rathmann prior to delivery, asking him to guarantee payment. Evidence was adduced that Rathmann orally promised to pay in the event the builder did not and that the goods were then delivered. Rathmann denied any such promise, raising the Statute of Frauds, and Al Booth's sued. Will Al Booth's prevail?

SELF-TEST QUESTIONS

1. As a general rule
    1. contracts do not have to be in writing to be enforceable
    2. contracts that can be performed in one year must be in writing
    3. all oral contracts are unenforceable
    4. a suretyship agreement need not be in writing to be enforceable
2. An exception to the UCC Statute of Frauds provision is
    1. the one-year rule
    2. the reply doctrine
    3. executor agreements
    4. all of the above
3. Rules that require certain contracts to be in writing are found in
    1. state statutory law
    2. the UCC
    3. the Statute of Frauds
    4. all of the above
4. The parol evidence rule
    1. applies only when contracts must be in writing
    2. does not apply to real estate contracts
    3. states that a written contract discharges all prior or contemporaneous promises that add to, vary, or conflict with it
    4. is designed to hold parties to promises they made during negotiations
5. A merger clause
    1. is required when goods are sold for $500 or more
    2. is used when two parcels of real estate are sold in the same contract
    3. invalidates a contract for the sale of securities
    4. evidences an intention that the written contract is the parties' full understanding

SELF-TEST AnswerS

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

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13: THIRD-PARTY RIGHTS

Learning Objectives

After reading this chapter, you should understand the following:

1. How an assignment of contract rights is made and how it operates
2. What a delegation of duties is and how it operates
3. Under what circumstances a person not a party to a contract can enforce it

In the life of a contract, the parties who originally made the agreement are not always the ones who ultimately carry it out. Businesses merge, employees change, and obligations may be shifted for practical or financial reasons. Contract law recognizes this reality by allowing parties, in many cases, to transfer their rights and duties to others.

The transfer of a contractual **right** is called an **assignment**, while the transfer of a contractual **duty** is called a **delegation**. These legal concepts make contracts more flexible, ensuring that benefits and responsibilities can move as circumstances demand. In commercial settings, assignments and delegations are especially common: lenders may sell loan rights, companies may delegate work to subcontractors, and landlords may assign rent rights to financial institutions.

Assignments and delegations illustrate how contracts can function as more than private promises—they can operate as valuable assets that circulate in the marketplace. At the same time, the law places limits on transfers to protect parties from unfair surprise, excessive burdens, or risks they did not bargain for.

Finally, it is worth noting that contractual benefits do not always flow only to the parties who signed the agreement. Sometimes, a contract is made with the intent to benefit someone else entirely. These **third-party beneficiaries**—such as a life insurance beneficiary or a business partner named in a supply agreement—may acquire legal rights under a contract even though they never signed it. Together, assignments, delegations, and third-party beneficiary rights demonstrate the broader reach of contract law beyond the immediate parties.

In this chapter, we turn our attention to contracts in which outsiders acquire rights or duties or both. Three types of outsiders merit examination:

1. Assignees (outsiders who acquire **rights** after the contract is made)
2. Delegatees (outsiders who acquire **duties** after the contract is made)
3. Third-party beneficiaries (outsiders who acquire rights when the original contract is made)

13.1: Assignment of Contract Rights
13.2: Delegation of Duties
13.3: Third-Party Beneficiaries
13.4: Cases
13.5: Summary and Exercises

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13.1: Assignment of Contract Rights

LEARNING OBJECTIVES

1. Understand what an assignment is and how it is made.
2. Recognize the effect of the assignment.
3. Know when assignments are not allowed.
4. Understand the concept of assignor's warranties.

The Concept of a Contract Assignment (Assignment of Contract Rights)

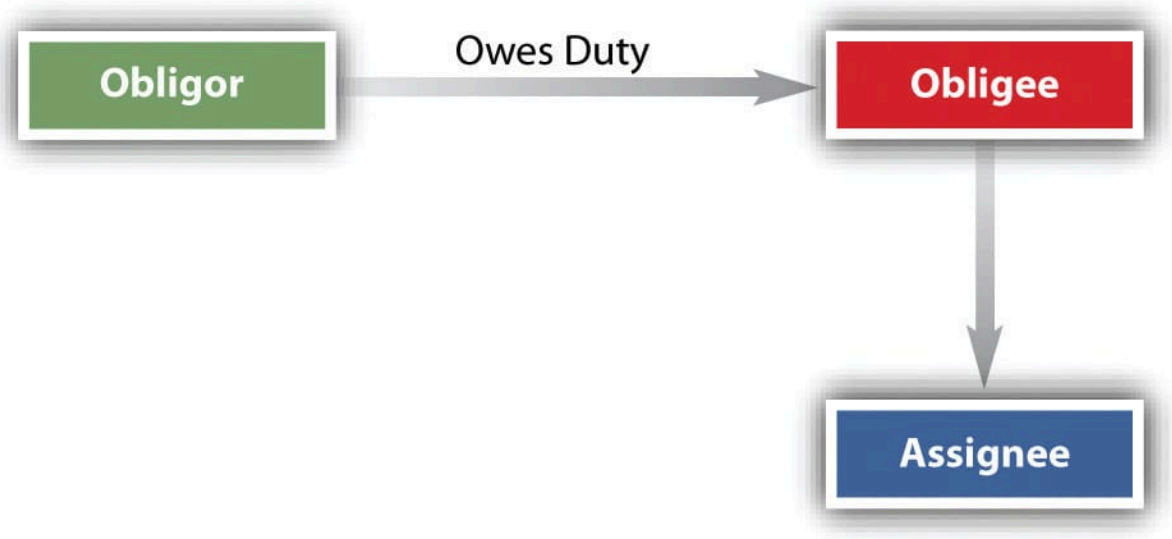
Contracts create both **rights** and **duties**. The party entitled to receive a benefit is called the **obligee**. That person may transfer their right to another person, known as the **assignee**. The act of transferring the right is called an **assignment**.

Once the transfer occurs, the original obligee (now the **assignor**) steps aside, and the assignee acquires the right to receive performance directly from the other party to the contract (the **obligor**). In short, the assignee "**stands in the shoes**" of the assignor.

Assignments are very common in business transactions:

- **Banking:** A bank may assign its rights under a mortgage or loan to another financial institution.
- **Accounts receivable financing:** A business may sell its outstanding invoices to a factoring company for immediate cash.
- **Leases:** A tenant may assign the right to occupy premises to another party, with the landlord's consent.

Figure 14.1 Assignment of Rights



Method of Assignment

Manifesting Assent

For an assignment to be valid, the assignor must clearly express the intention to transfer rights immediately. The intention must be definite and present—not a vague promise to transfer later.

- **Valid Assignment Example:** "I hereby assign my right to collect $5,000 from James under our contract to Maria."
- **Invalid Promise Example:** "I will assign my right to you next month." (This is a promise to assign, not an actual assignment.)

Acceptance and Revocation

Most assignments require no special acceptance—especially when the assignee gives **consideration** (something of value) in exchange for the assignment. In those cases, the assignment is binding and cannot be revoked without the assignee's consent.

Issues arise mainly with **gratuitous assignments** (those given as gifts). These are usually revocable unless:

- The assignee accepts the gift, or
- The assignor provides written notice of the assignment.
- **Example:** John assigns his right to collect rent from a tenant to his brother as a gift. Unless his brother accepts or receives written notice, John may revoke the assignment.

Notice to the Obligor

Once an assignment is made, the **obligor**—the party who owes performance—should be informed so they know where to direct their performance. Strictly speaking, **notice to the obligor is not required** for an assignment to be valid. However, whether or not notice is given can have serious consequences.

If the obligor has **no notice** of the assignment and performs by paying or delivering to the **assignor**, the obligor is discharged. The obligation has been satisfied, even though the assignee did not receive performance. In that situation, the assignor cannot keep the benefit; he owes it to the assignee.

But once the **obligor has notice** of the assignment, the rules change. If the obligor still performs to the assignor, that performance does not count, and the assignee can recover directly from either the obligor or the assignor. This could place the obligor in the unfair position of having to perform **twice**. (See *Aldana v. Colonial Palms Plaza*.)

Because of this risk, an obligor who receives notice of an assignment from someone claiming to be the assignee has a legitimate concern: *How do I know the assignment is real?* After all, anyone could show up and say, *"I'm the assignee of your contract with the bank. From now on, pay me the $500 a month, not the bank."* The law recognizes this concern

Effect of Assignment

General Rule: Standing in the Shoes" of the Assignor

When a right is assigned, the **assignee** does not receive anything more than what the **assignor** had. Instead, the assignee effectively "stands in the shoes" of the assignor. This means the assignee acquires all the rights the assignor had against the **obligor**, but also takes those rights **subject to any defenses or claims** the obligor could have raised against the assignor.

In other words, if the obligor could have refused to perform for the assignor, the obligor can refuse to perform for the assignee on the same grounds. The assignment does not improve or enlarge the underlying rights—it simply transfers them.

The **Uniform Commercial Code (UCC) § 9-318(1)** reinforces this principle in the context of accounts: the assignee is bound by all the terms of the contract between the debtor (obligor) and the creditor-assignor.

Example

Dealer sells a car to Buyer under a contract where Buyer must pay **$300 per month**, and the car comes with a **50,000-mile warranty**. Before 50,000 miles, the car breaks down, and Dealer refuses to honor the warranty. Buyer spends **$250** on repairs and deducts that amount from the next installment payment (a practice known as a **setoff**).

Later, Dealer assigns the contract to Assignee. Because Assignee "stands in Dealer's shoes," Buyer has the same right to set off the $250 repair cost against the installment owed to Assignee. The assignment does not eliminate Buyer's defenses—it simply changes the party to whom payment is owed.

Exceptions

The **"shoe rule"**—that an assignee takes only the rights the assignor had—does not apply in two situations: when a negotiable instrument is transferred to a **holder in due course** or when the obligor has **waived defenses** against an assignee. Even then, important limits apply: certain "real defenses" (like duress or fraud) always remain available, and consumer protection laws and FTC regulations often prevent waivers in consumer transactions.

When Assignments Are Not Allowed

The general rule is that most contract rights can be assigned. But there are important **exceptions** designed to protect fairness and prevent abuse. Below are the major situations in which assignments are restricted or prohibited.

Material Change in Duties of the Obligor

An assignment is ineffective if it would **materially alter the obligor's duties**. The law allows routine changes (such as redirecting payments), but not changes that would fundamentally shift the nature of the performance.

- **Example 1:** A Centerville Times subscriber assigns his right to newspaper delivery to another person in town. This is valid because delivery obligations are routine and unchanged.
- **Example 2:** A parent hires a babysitter to care for her child every Saturday evening. The parent cannot assign her right to child care to a neighbor's child without the babysitter's consent, because caring for a different child would materially change the babysitter's duties.

Assignments are generally valid when the contract does not involve a personal relationship—but consent may still be required in special contracts.

Assignment of Personal Rights

Contracts involving **personal rights** cannot be assigned, because it matters to the obligor *who* receives the performance.

- **Example 1:** A student agrees to do research work for a professor she admires. The professor assigns the contract to another colleague whom the student dislikes. The assignment is invalid.
- **Example 2:** An insurance company issues a policy to a careful sixty-five-year-old driver. He cannot assign the policy to his reckless teenage grandson, because the insurer contracted based on his personal risk profile.

Personal services and most tenancy agreements fall under this category.

Assignment Forbidden by Statute or Public Policy

Some assignments are restricted by law or public policy. Legislatures often step in to prevent exploitation or unfairness.

- **Example 1:** Federal and state laws limit the assignment of future wages to protect workers from selling off their income due to financial hardship.
- **Example 2:** Certain public benefits (like workers' compensation) cannot be assigned, to ensure they serve their intended purpose.

Contracts That Prohibit Assignment

Parties may include a **no-assignment clause** in their agreement. Courts usually respect these clauses, but with limitations.

- Under the **Restatement (Second) of Contracts §322** and **UCC §2-210(3)**, a general prohibition on assigning "the contract" usually bars only the delegation of duties, not the assignment of rights.
- **Example 1:** A lease may forbid a tenant from subletting without the landlord's consent.
- **Example 2:** Even if a land sale contract prohibits assignment, some states still allow the buyer to assign the right to receive title after paying in full.

The UCC also invalidates clauses that attempt to prohibit assigning **rights to damages** or sums already due.

Future Contracts

The law distinguishes between **future rights under an existing contract** (which may be assigned) and **rights under a future contract** (which may not).

- **Example 1:** Ben has a standing deal to shovel Mrs. Robinson's walkway for $20 per snowfall. He assigns his friend the right to his next four payments. The assignment is valid.
- **Example 2:** Ben cannot assign rights under a snow-shoveling contract he *hopes* to make next year, because no such contract exists yet.

Partial Assignments

Assignments may cover only part of a contractual right if the obligation can be separated. This is most common with money payments.

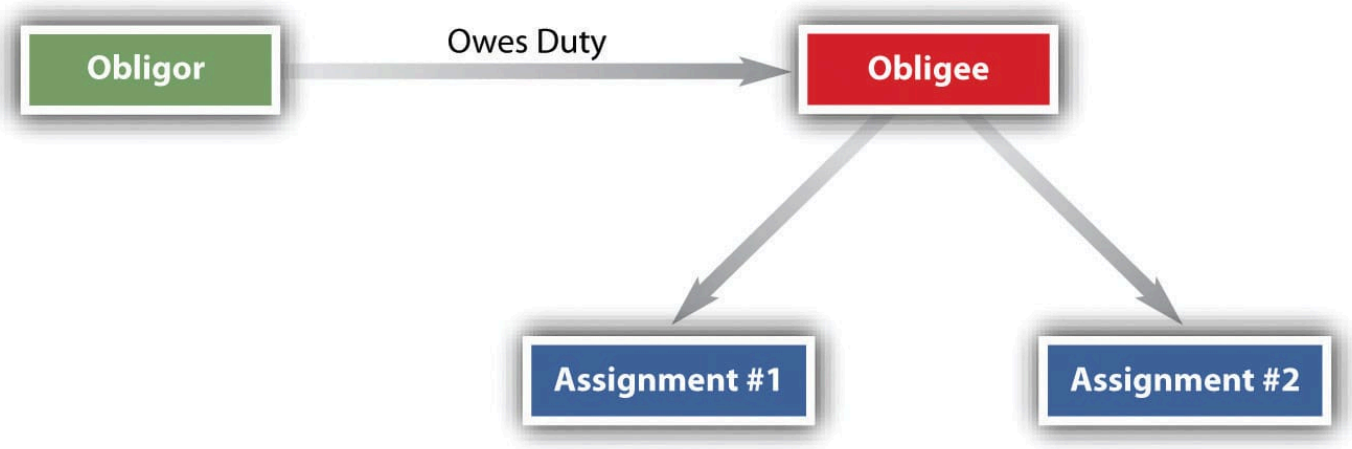
- **Example 1:** Ben assigns half ($50) of the $100 Mrs. Robinson owes him to a friend. The assignment is valid.
- **Example 2:** If Mrs. Robinson disputes the arrangement, both Ben and the friend must join in a lawsuit to enforce payment, ensuring all parties are present in court.

Successive Assignments

Sometimes an assignor wrongfully assigns the same right to more than one assignee. Priority depends on jurisdiction and circumstances.

- **General Rule (U.S.):** The **first assignee in time** usually prevails, unless the assignment was revocable or invalid.
- **Exceptions:** A later assignee may prevail if he qualifies as a **bona fide purchaser (BFP)**—that is, he (1) gave consideration in good faith, (2) had no knowledge of earlier assignments, and (3) obtained performance, judgment, or tangible evidence of the right. In that situation, the later assignee's interest will take priority over the earlier one.
- **English Rule (some states):** The first assignee to give **notice to the obligor** has priority, regardless of the order of assignment.
- **UCC Article 9:** For assignments subject to filing, the first assignee to file will prevail.

Figure 14.2 Successive Assignments



Assignor's Warranties

An **assignor**—the person transferring a contractual right—carries certain legal responsibilities when making an assignment. He

cannot casually assign the same interest multiple times or transfer rights he does not actually have without facing liability. To protect assignees, the law recognizes **assignor's warranties**, unless the contract explicitly provides otherwise.

When a right is assigned **for value** (not as a gift), the assignor implicitly promises:

1. **That the assignment is valid** – The assignor will not take steps to defeat or undo the assignment.
2. **That he has the right to assign** – The assignor truly owns the right being transferred.
3. **That there are no undisclosed defenses** – The obligor does not have defenses that would make the right worthless.

However, the assignor does **not** guarantee the obligor's performance. An assignment is not a promise that the obligor is solvent or will actually pay; it only guarantees that the right itself is genuine.

KEY TAKEAWAY

Generally, it is OK for an obligee to assign the right to receive contractual performance from the obligor to a third party. The effect of the assignment is to make the assignee stand in the shoes of the assignor, taking all the latter's rights and all the defenses against nonperformance that the obligor might raise against the assignor. But the obligor may agree in advance to waive defenses against the assignee, unless such waiver is prohibited by law.

There are some exceptions to the rule that contract rights are assignable. Some, such as personal rights, are not circumstances where the obligor's duties would materially change, cases where assignability is forbidden by statute or public policy, or, with some limits, cases where the contract itself prohibits assignment. Partial assignments and successive assignments can happen, and rules govern the resolution of problems arising from them.

When the assignor makes the assignment, that person makes certain warranties, express or implied, to the assignee, basically to the effect that the assignment is good and the assignor knows of no reason why the assignee will not get performance from the obligor.

EXERCISES

1. If Able makes a valid assignment to Baker of his contract to receive monthly rental payments from Tenant, how is Baker's right different from what Able's was?
2. Able made a valid assignment to Baker of his contract to receive monthly purchase payments from Carr, who bought an automobile from Able. The car had a 180-day warranty, but the car malfunctioned within that time. Able had quit the auto business entirely. May Carr withhold payments from Baker to offset the cost of needed repairs?
3. Assume in the case in Exercise 2 that Baker knew Able was selling defective cars just before his (Able's) withdrawal from the auto business. How, if at all, does that change Baker's rights?
4. Why are leases generally not assignable? Why are insurance contracts not assignable?

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13.2: Delegation of Duties

LEARNING OBJECTIVES

1. Know what a delegation of duty is.
2. Recognize how liability remains on the delegator following a delegation.
3. Understand what duties may not be delegated.

Delegation of Duties

Introductory Scenario

Imagine this: Sarah, a homeowner, hires Prime Builders to remodel her kitchen. The contract states that Prime Builders will complete the work for $50,000. After the agreement is signed, Prime Builders decides to subcontract the plumbing work to AquaPro Plumbing. Sarah wonders: “Do I have to accept performance from this new company? And if AquaPro makes mistakes, who is responsible—Prime Builders or AquaPro?”

This scenario illustrates the concept of **delegation of duties**—when one party to a contract transfers their responsibility to perform to someone else.

General Rule

Up to this point, we have focused on the **assignment of rights** (usually involving money payments). But contracts create **duties** as well as rights. Just as rights can be assigned, **duties may be delegated**.

- The party who transfers the duty is the **delegator** (Prime Builders).
- The party who assumes the duty is the **delegatee** (AquaPro Plumbing).
- The party entitled to performance is the **obligee** (Sarah).

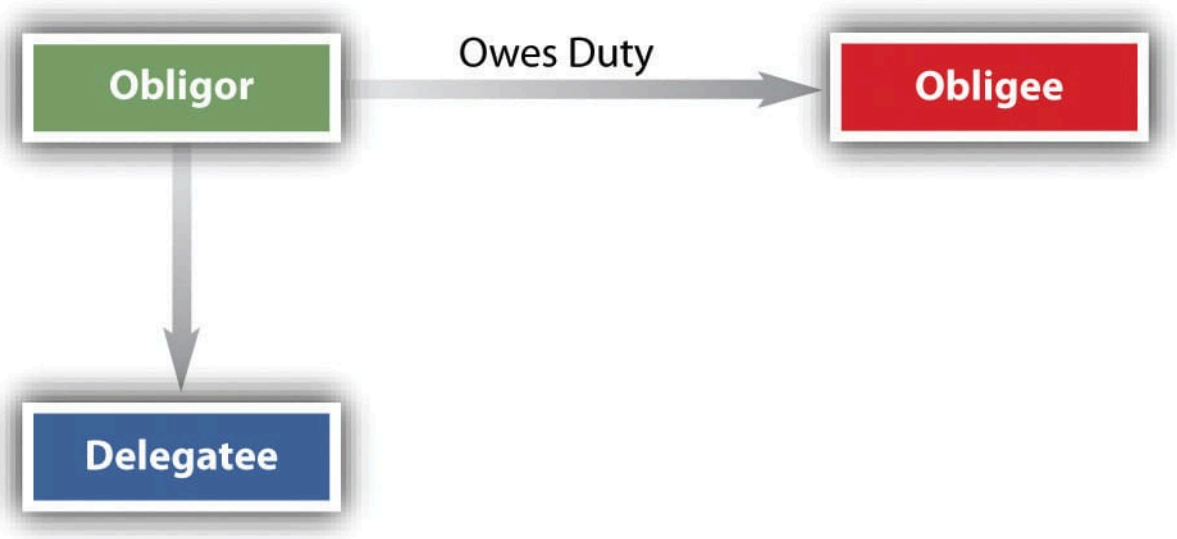
Unless the contract itself, or public policy, prohibits it, delegation is generally enforceable.

Common Law and the UCC

- **Common Law (majority rule):** An assignment of rights alone does not automatically include a delegation of duties. The delegator must expressly delegate.
- **UCC § 2-210(4) and minority rule:** An assignment of “the contract” or of “all my rights under the contract” is treated as both an assignment of rights and a delegation of duties. By accepting such an assignment, the delegatee is understood to have promised to perform.

Scenario tie-in: If Prime Builders simply assigned Sarah’s payments to a financing company, only the right to payment would be transferred. But if they assigned “the contract,” that would also imply AquaPro takes on the duty of performing the remodeling work.

Figure 14.3 Delegation of Duties



Liability After Delegation

Delegating a duty does **not** automatically release the delegator.

- **Delegator remains liable:** Prime Builders is still on the hook to Sarah, even if AquaPro fails to perform.
- **Obligee may enforce against both:** Sarah could sue AquaPro for poor plumbing, but she could also hold Prime Builders accountable, since Prime Builders originally promised to perform.

This contrasts with **assignments**, where the assignor generally steps out once the right is transferred.

Novation

A delegator can only escape liability through a **novation**—a new agreement in which the obligee agrees to release the original obligor and accept the delegatee as a substitute.

- **Example:** If Sarah, Prime Builders, and AquaPro all agree that AquaPro will fully take over the contract, and Prime Builders is released, this constitutes a novation. Sarah can no longer hold Prime Builders liable if AquaPro defaults.

Nondelegable Duties

Not all duties can be delegated.

1. **Personal Services**
   If the contract involves unique skill, talent, or trust, performance must be personal.
   - Example: If Sarah had hired a famous interior designer known for her unique artistic vision, that designer could not delegate the design work to an assistant without Sarah's consent.
2. **Public Policy**
   Some duties are barred from delegation because they are tied to public trust or responsibility.
   - Example: A public official cannot delegate their elected duties to a private citizen.
3. **Contractual Prohibition**
   The parties themselves may agree to forbid delegation. Courts generally enforce such clauses.
   - UCC § 2-210(3): In sales contracts, a prohibition on assigning "the contract" is interpreted as a bar on delegating duties.

Scenario tie-in: If Sarah's remodeling contract explicitly stated, "Prime Builders must personally perform all work and may not delegate duties," then AquaPro could not take over without Sarah's approval.

KEY TAKEAWAY

Most contractual duties may be delegated, but the delegator remains liable unless there is a **novation**. Some duties—especially those involving personal skill, public policy, or express contractual prohibitions—are nondelegable.

Scenario wrap-up: In Sarah's case, Prime Builders may delegate routine tasks like plumbing to AquaPro, but Prime Builders remains responsible for the final result unless Sarah formally agrees to release them through a novation.

EXERCISES

1. What is the difference between an assignment and a delegation?
2. Under what circumstances is the delegator discharged from liability on the contract?

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13.3: Third-Party Beneficiaries

LEARNING OBJECTIVES

1. Know what a third-party beneficiary is, and what the types of such beneficiaries are.
2. Recognize the rights obtained by third-party beneficiaries.
3. Understand when the public might be a third-party beneficiary of government contracts.

The fundamental issue with third-party beneficiaries gets to this: can a person who is not a party to a contract sue to enforce its terms?

The General Rule

Imagine this scenario: Olivia takes out a life insurance policy with Evergreen Insurance. She faithfully pays her monthly premiums. The policy states that, upon her death, Evergreen will pay $250,000 to her son, Marcus. Years later, when Olivia passes away, Evergreen refuses to pay Marcus, arguing that Marcus was never a party to the contract between Olivia and the insurer.

This raises an important question: can Marcus enforce the agreement even though he never signed it?

Under traditional contract law, only the parties who made a contract have the right to enforce it. Outsiders—those who were not part of the agreement—are said to lack **privity of contract**, meaning they have no direct legal relationship with the contracting parties.

But there is an exception. If a contract is made with the **clear purpose of benefiting someone outside the agreement**, that person is an **intended beneficiary** and has legal rights. This doctrine allows Marcus to enforce Olivia's life insurance contract.

By contrast, someone who benefits only indirectly—called an **incidental beneficiary**—has no enforceable rights.

Two Types of Third-Party Beneficiaries

The **Restatement (Second) of Contracts** defines an intended beneficiary as a third party whom the contracting parties specifically intended to benefit. There are two main types: **creditor beneficiaries** and **donee beneficiaries**.

1. Creditor Beneficiary

A creditor beneficiary arises when the promisee owes a debt to the third party, and the promisor agrees to discharge that debt.

- Example: Alex owes Bella $5,000. Alex then contracts with Chris, agreeing to paint Chris's house if Chris pays $5,000 directly to Bella. Here, Bella is a **creditor beneficiary**. If Chris fails to pay, Bella may sue Chris directly, even though she wasn't part of the original bargain.
- Tie-in to scenario: If Olivia had taken out a policy requiring Evergreen to pay Marcus directly to satisfy a debt she owed him, Marcus would also qualify as a creditor beneficiary.

2. Donee Beneficiary

A donee beneficiary receives a contractual benefit as a gift rather than to satisfy a debt.

- Example: Olivia's life insurance policy is a classic case. She (the promisee) paid premiums to Evergreen (the promisor) with the intent that Marcus (the donee beneficiary) would receive the payout. Marcus, therefore, has standing to enforce the policy.
- Another Example: Anna contracts with a landscaper to improve her yard so her elderly mother can enjoy the view. The mother is a **donee beneficiary** who can enforce performance if the landscaper fails to deliver.

Incidental Beneficiaries

Not everyone who benefits from a contract is an intended beneficiary. If the benefit is merely a by-product, the third party is only an **incidental beneficiary** with no rights to sue.

- Example: Suppose Olivia hires a contractor to remodel her home. Marcus enjoys the upgraded living space but was never the intended recipient of the benefit. He is only an incidental beneficiary and cannot sue if the contractor performs poorly.

Limits on Beneficiary Rights

Even intended beneficiaries are not absolute winners. Their rights depend on the terms of the contract.

- Example: If Olivia stopped paying her premiums, Marcus's rights would fail, because Evergreen could raise the same defense against Marcus that it could have raised against Olivia.

Modification of Beneficiary Rights

The parties who made the contract may generally modify or cancel the benefit **until the beneficiary's rights vest**.

Vesting occurs when:

1. The contract itself grants immediate rights to the beneficiary,
2. The beneficiary assents to the benefit,
3. The beneficiary reasonably relies on the promise to their detriment, or
4. The beneficiary files suit.

- Example: If Evergreen and Olivia agreed to cancel the life insurance policy before Marcus knew about it, Marcus would have no rights. But once Marcus learned of the policy, relied on it, or brought a lawsuit, his rights would vest and could not be canceled without his consent.

Government Contracts and the Public

Generally, members of the public are only **incidental beneficiaries** of government contracts.

- Example: If a county contracts with a construction company to build a new bridge, nearby businesses (like a restaurant anticipating more traffic) cannot sue if the project is delayed. The contract was not intended to benefit them directly.
- Exception: Where contracts are tailored to specific individuals, those individuals may be intended beneficiaries. For example, if a city contracts with a towing company to provide emergency roadside assistance for stranded motorists, those motorists may enforce the contract when the service fails.

KEY TAKEAWAY

Normally, only contracting parties can enforce a contract. But **intended third-party beneficiaries**—such as creditor beneficiaries and donee beneficiaries—are exceptions to the rule and may sue to enforce their rights. By contrast, **incidental beneficiaries** cannot.

Returning to our scenario: Marcus, as the intended beneficiary of Olivia's life insurance contract, has enforceable rights against Evergreen Insurance. If Olivia had never designated Marcus and he only benefited indirectly, he would be an incidental beneficiary and unable to enforce the agreement.

EXERCISES

1. What are the two types of intended beneficiaries?

2. Smith contracted to deliver a truck on behalf of Truck Sales to Byers, who had purchased it from Truck Sales. Smith was entitled to payment by Byers for the delivery. The truck was defective. May Byers withhold payment from Smith to offset the repair costs?
3. Why is the public not usually considered an intended beneficiary of contracts made by the government?

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13.4: Cases

Nonassignable Rights

Nassau Hotel Co. v. Barnett & Barse Corporation

147 N.Y.S. 283 (1914)

McLaughlin, J.

Plaintiff owns a hotel at Long Beach, L. I., and on the 21st of November, 1912, it entered into a written agreement with the individual defendants Barnett and Barse to conduct the same for a period of years....Shortly after this agreement was signed, Barnett and Barse organized the Barnett & Barse Corporation with a capital stock of $10,000, and then assigned the agreement to it. Immediately following the assignment, the corporation went into possession and assumed to carry out its terms. The plaintiff thereupon brought this action to cancel the agreement and to recover possession of the hotel and furniture therein, on the ground that the agreement was not assignable. [Summary judgment in favor of the plaintiff, defendant corporation appeals.]

The only question presented is whether the agreement was assignable. It provided, according to the allegations of the complaint, that the plaintiff leased the property to Barnett and Barse with all its equipment and furniture for a period of three years, with a privilege of five successive renewals of three years each. It expressly provided:

'That said lessees...become responsible for the operation of the said hotel and for the upkeep and maintenance thereof and of all its furniture and equipment in accordance with the terms of this agreement and the said lessees shall have the exclusive possession, control and management thereof. * * * The said lessees hereby covenant and agree that they will operate the said hotel at all times in a first-class business-like manner, keep the same open for at least six (6) months of each year, * * *' and 'in lieu of rental the lessor and lessees hereby covenant and agree that the gross receipts of such operation shall be, as received, divided between the parties hereto as follows: (a) Nineteen per cent. (19%) to the lessor. * * * In the event of the failure of the lessees well and truly to perform the covenants and agreements herein contained,' they should be liable in the sum of $50,000 as liquidated damages. That 'in consideration and upon condition that the said lessees shall well and faithfully perform all the covenants and agreements by them to be performed without evasion or delay the said lessor for itself and its successors, covenants and agrees that the said lessees, their legal representatives and assigns may at all times during said term and the renewals thereof peaceably have and enjoy the said demised premises.' And that 'this agreement shall inure to the benefit of and bind the respective parties hereto, their personal representatives, successors and assigns.'

The complaint further alleges that the agreement was entered into by plaintiff in reliance upon the financial responsibility of Barnett and Barse, their personal character, and especially the experience of Barnett in conducting hotels; that, though he at first held a controlling interest in the Barnett & Barse Corporation, he has since sold all his stock to the defendant Barse, and has no interest in the corporation and no longer devotes any time or attention to the management or operation of the hotel.

...[C]learly...the agreement in question was personal to Barnett and Barse and could not be assigned by them without the plaintiff's consent. By its terms the plaintiff not only entrusted them with the care and management of the hotel and its furnishings—valued, according to the allegations of the complaint, at more than $1,000,000—but agreed to accept as rental or compensation a percentage of the gross receipts. Obviously, the receipts depended to a large extent upon the management, and the care of the property upon the personal character and responsibility of the persons in possession. When the whole agreement is read, it is apparent that the plaintiff relied, in making it, upon the personal covenants of Barnett and Barse. They were financially responsible. As already said, Barnett had had a long and successful experience in managing hotels, which was undoubtedly an inducing cause for plaintiff's making the agreement in question and for personally obligating them to carry out its terms.

It is suggested that because there is a clause in the agreement to the effect that it should 'inure to the benefit of and bind the respective parties hereto, their personal representatives and assigns,' that Barnett and Barse had a right to assign it to the corporation. But the intention of the parties is to be gathered, not from one clause, but from the entire instrument [Citation] and when it is thus read it clearly appears that Barnett and Barse were to personally carry out the terms of the agreement and did not have a right to assign it. This follows from the language used, which shows that a personal trust or confidence was reposed by the plaintiff in Barnett and Barse when the agreement was made.

In [Citation] it was said: “Rights arising out of contract cannot be transferred if they…involve a relation of personal confidence such that the party whose agreement conferred those rights must have intended them to be exercised only by him in whom he actually confided.”

This rule was applied in [Citation] the court holding that the plaintiff—the assignee—was not only technically, but substantially, a different entity from its predecessor, and that the defendant was not obliged to entrust its money collected on the sale of the presses to the responsibility of an entirely different corporation from that with which it had contracted, and that the contract could not be assigned to the plaintiff without the assent of the other party to it.

The reason which underlies the basis of the rule is that a party has the right to the benefit contemplated from the character, credit, and substance of him with whom he contracts, and in such case he is not bound to recognize…an assignment of the contract.

The order appealed from, therefore, is affirmed.

CASE QUESTIONS

1. The corporation created to operate the hotel was apparently owned and operated by the same two men the plaintiff leased the hotel to in the first place. What objection would the plaintiff have to the corporate entity—actually, of course, a legal fiction—owning and operating the hotel?
2. The defendants pointed to the clause about the contract inuring to the benefit of the parties “and assigns.” So the defendants assigned the contract. How could that not be allowed by the contract’s own terms?
3. What is the controlling rule of law upon which the outcome here depends?

Assignment Includes Delegation

Rose v. Vulcan Materials Co.

194 S.E.2d 521 (N.C. 1973)

Huskins, J.

…Plaintiff [Rose], after leasing his quarry to J. E. Dooley and Son, Inc., promised not to engage in the rock-crushing business within an eight-mile radius of [the city of] Elkin for a period of ten years. In return for this promise, J. E. Dooley and Son, Inc., promised, among other things, to furnish plaintiff stone f.o.b. the quarry site at Cycle, North Carolina, at stipulated prices for ten years….

By a contract effective 23 April 1960, Vulcan Materials Company, a corporation…, purchased the stone quarry operations and the assets and obligations of J. E. Dooley and Son, Inc….[Vulcan sent Rose a letter, part of which read:]

Mr. Dooley brought to us this morning the contracts between you and his companies, copies of which are attached. This is to advise that Vulcan Materials Company assumes all phases of these contracts and intends to carry out the conditions of these contracts as they are stated.

In early 1961 Vulcan notified plaintiff that it would no longer sell stone to him at the prices set out in [the agreement between Rose and Dooley] and would thereafter charge plaintiff the same prices charged all of its other customers for stone. Commencing 11 May 1961, Vulcan raised stone prices to the plaintiff to a level in excess of the prices specified in [the Rose-Dooley agreement].

At the time Vulcan increased the prices of stone to amounts in excess of those specified in [the Rose-Dooley contract], plaintiff was engaged in his ready-mix cement business, using large quantities of stone, and had no other practical source of supply. Advising Vulcan that he intended to sue for breach of contract, he continued to purchase stone from Vulcan under protest….

The total of these amounts over and above the prices specified in [the Rose-Dooley contract] is $25,231.57, [about $152,000 in 2010 dollars] and plaintiff seeks to recover said amount in this action.

The [Rose-Dooley] agreement was an executory bilateral contract under which plaintiff’s promise not to compete for ten years gained him a ten-year option to buy stone at specified prices. In most states, the assignee of an executory bilateral contract is not liable to anyone for the nonperformance of the assignor’s duties thereunder unless he expressly promises his assignor or the other contracting party to perform, or ‘assume,’ such duties….These states refuse to imply a promise to perform the duties, but

if the assignee expressly promises his assignor to perform, he is liable to the other contracting party on a third-party beneficiary theory. And, if the assignee makes such a promise directly to the other contracting party upon a consideration, of course he is liable to him thereon. [Citation]

A minority of states holds that the assignee of an executory bilateral contract under a general assignment becomes not only assignee of the rights of the assignor but also delegatee of his duties; and that, absent a showing of contrary intent, the assignee impliedly promises the assignor that he will perform the duties so delegated. This rule is expressed in Restatement, Contracts, s 164 (1932) as follows:

(1) Where a party under a bilateral contract which is at the time wholly or partially executory on both sides purports to assign the whole contract, his action is interpreted, in the absence of circumstances showing a contrary intention, as an assignment of the assignor's rights under the contract and a delegation of the performance of the assignor's duties.

(2) Acceptance by the assignee of such an assignment is interpreted, in the absence of circumstances showing a contrary intention, as both an assent to become an assignee of the assignor's rights and as **a promise to the assignor to assume the performance of the assignor's duties**.' (emphasis added)

We...adopt the Restatement rule and expressly hold that the assignee under a general assignment of an executory bilateral contract, in the absence of circumstances showing a contrary intention, becomes the delegatee of his assignor's duties and impliedly promises his assignor that he will perform such duties.

The rule we adopt and reaffirm here is regarded as the more reasonable view by legal scholars and textwriters. Professor Grismore says:

It is submitted that the acceptance of an assignment in this form does presumptively import a tacit promise on the part of the assignee to assume the burdens of the contract, and that this presumption should prevail in the absence of the clear showing of a contrary intention. The presumption seems reasonable in view of the evident expectation of the parties. The assignment on its face indicates an intent to do more than simply to transfer the benefits assured by the contract. It purports to transfer the contract as a whole, and since the contract is made up of both benefits and burdens both must be intended to be included....Grismore, Is the Assignee of a Contract Liable for the Nonperformance of Delegated Duties? 18 Mich.L.Rev. 284 (1920).

In addition, with respect to transactions governed by the Uniform Commercial Code, an assignment of a contract in general terms is a delegation of performance of the duties of the assignor, and its acceptance by the assignee constitutes a promise by him to perform those duties. Our holding in this case maintains a desirable uniformity in the field of contract liability.

We further hold that the other party to the original contract may sue the assignee as a third-party beneficiary of his promise of performance which he impliedly makes to his assignor, under the rule above laid down, by accepting the general assignment. *Younce v. Lumber Co*., [Citation] (1908), holds that where the assignee makes an express promise of performance to his assignor, the other contracting party may sue him for breach thereof. We see no reason why the same result should not obtain where the assignee breaches his promise of performance implied under the rule of Restatement s 164. 'That the assignee is liable at the suit of the third party where he expressly assumes and promises to perform delegated duties has already been decided in a few cases (citing Younce). If an express promise will support such an action it is difficult to see why a tacit promise should not have the same effect.' Grismore, supra. Parenthetically, we note that such is the rule under the Uniform Commercial Code, [2-210].

We now apply the foregoing principles to the case at hand. The contract of 23 April 1960, between defendant and J. E. Dooley and Son, Inc., under which, as stipulated by the parties, 'the defendant purchased the assets and obligations of J. E. Dooley and Son, Inc.,' was a general assignment of all the assets and obligations of J. E. Dooley and Son, Inc., including those under [the Rose-Dooley contract]. When defendant accepted such assignment it thereby became delegatee of its assignor's duties under it and impliedly promised to perform such duties.

When defendant later failed to perform such duties by refusing to continue sales of stone to plaintiff at the prices specified in [the Rose-Dooley contract], it breached its implied promise of performance and plaintiff was entitled to bring suit thereon as a third-party beneficiary.

The decision...is reversed with directions that the case be certified to the Superior Court of Forsyth County for reinstatement of the judgment of the trial court in accordance with this opinion.

CASE QUESTIONS

1. Why did Rose need the crushed rock from the quarry he originally leased to Dooley?
2. What argument did Vulcan make as to why it should not be liable to sell crushed rock to Rose at the price set out in the Rose-Dooley contract?
3. What rule did the court here announce in deciding that Vulcan was required to sell rock at the price set out in the Rose-Dooley contract? That is, what is the controlling rule of law in this case?

Third party Beneficiaries and Foreseeable Damages

Kornblut v. Chevron Oil Co.

62 A.D.2d 831 (N.Y. 1978)

Hopkins, J.

The plaintiff-respondent has recovered a judgment after a jury trial in the sum of $519,855.98 [about $1.9 million in 2010 dollars] including interest, costs and disbursements, against Chevron Oil Company (Chevron) and Lawrence Ettinger, Inc. (Ettinger) (hereafter collectively referred to as defendants) for damages arising from the death and injuries suffered by Fred Kornblut, her husband. The case went to the jury on the theory that the decedent was the third-party beneficiary of a contract between Chevron and the New York State Thruway Authority and a contract between Chevron and Ettinger.

On the afternoon of an extremely warm day in early August, 1970 the decedent was driving northward on the New York State Thruway. Near Sloatsburg, New York, at about 3:00 p.m., his automobile sustained a flat tire. At the time the decedent was accompanied by his wife and 12-year-old son. The decedent waited for assistance in the 92 degree temperature.

After about an hour a State Trooper, finding the disabled car, stopped and talked to the decedent. The trooper radioed Ettinger, which had the exclusive right to render service on the Thruway under an assignment of a contract between Chevron and the Thruway Authority. Thereafter, other State Troopers reported the disabled car and the decedent was told in each instance that he would receive assistance within 20 minutes.

Having not received any assistance by 6:00 p.m., the decedent attempted to change the tire himself. He finally succeeded, although he experienced difficulty and complained of chest pains to the point that his wife and son were compelled to lift the flat tire into the trunk of the automobile. The decedent drove the car to the next service area, where he was taken by ambulance to a hospital; his condition was later diagnosed as a myocardial infarction. He died 28 days later.

Plaintiff sued, *inter alia*, Chevron and Ettinger alleging in her complaint causes of action sounding in negligence and breach of contract. We need not consider the issue of negligence, since the Trial Judge instructed the jury only on the theory of breach of contract, and the plaintiff has recovered damages for wrongful death and the pain and suffering only on that theory.

We must look, then, to the terms of the contract sought to be enforced. Chevron agreed to provide "rapid and efficient roadside automotive service on a 24-hour basis from each gasoline service station facility for the areas...when informed by the authority or its police personnel of a disabled vehicle on the Thruway". Chevron's vehicles are required "to be used and operated in such a manner as will produce adequate service to the public, as determined in the authority's sole judgment and discretion". Chevron specifically covenanted that it would have "sufficient roadside automotive service vehicles, equipment and personnel to provide roadside automotive service to disabled vehicles within a maximum of thirty (30) minutes from the time a call is assigned to a service vehicle, subject to unavoidable delays due to extremely adverse weather conditions or traffic conditions."...

In interpreting the contract, we must bear in mind the circumstances under which the parties bargained. The New York Thruway is a limited access toll highway, designed to move traffic at the highest legal speed, with the north and south lanes separated by green strips. Any disabled vehicle on the road impeding the flow of traffic may be a hazard and inconvenience to the other users. The income realized from tolls is generated from the expectation of the user that he will be able to travel swiftly and smoothly along the Thruway. Consequently, it is in the interest of the authority that disabled vehicles will be repaired or removed quickly to the end that any hazard and inconvenience will be minimized. Moreover, the design and purpose of the highway make difficult, if not impossible, the summoning of aid from garages not located on the Thruway. The movement of a large number of vehicles at high speed creates a risk to the operator of a vehicle who attempts to make his own repairs, as well as to the other users. These considerations clearly prompted the making of contracts with service organizations which would be located at points near in distance and time on the Thruway for the relief of distressed vehicles.

Thus, it is obvious that, although the authority had an interest in making provision for roadside calls through a contract, there was also a personal interest of the user served by the contract. Indeed, the contract provisions regulating the charges for calls and commanding refunds be paid directly to the user for overcharges, evince a protection and benefit extended to the user only. Hence, in the event of an overcharge, the user would be enabled to sue on the contract to obtain a recovery....Here the contract contemplates an individual benefit for the breach running to the user....

By choosing the theory of recovery based on contract, it became incumbent on the plaintiff to show that the injury was one which the defendants had reason to foresee as a probable result of the breach, under the ancient doctrine of Hadley v Baxendale [Citation], and the cases following it...in distinction to the requirement of proximate cause in tort actions....

The death of the decedent on account of his exertion in the unusual heat of the midsummer day in changing the tire cannot be said to have been within the contemplation of the contracting parties as a reasonably foreseeable result of the failure of Chevron or its assignee to comply with the contract....

The case comes down to this, then, in our view: though the decedent was the intended beneficiary to sue under certain provisions of the contract—such as the rate specified for services to be rendered—he was not the intended beneficiary to sue for consequential damages arising from personal injury because of a failure to render service promptly. Under these circumstances, the judgment must be reversed and the complaint dismissed, without costs or disbursements.

[Martuscello, J., concurred in the result but opined that the travelling public was not an intended beneficiary of the contract.]

CASE QUESTIONS

1. Chevron made two arguments as to why it should not be liable for Mr. Kornblut's death. What were they?
2. Obviously, when Chevron made the contract with the New York State Thruway Authority, it did not know Mr. Kornblut was going to be using the highway. How could he, then, be an intended beneficiary of the contract?
3. Why was Chevron not found liable for Mr. Kornblut's death when, clearly, had it performed the contract properly, he would not have died?

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13.5: Summary and Exercises

Summary

The general rule that the promisee may assign any right has some exceptions—for example, when the promisor's obligation would be materially changed. Of course the contract itself may prohibit assignment, and sometimes statutes preclude it. Knowing how to make the assignment effective and what the consequences of the assignment are on others is worth mastering. When, for example, does the assignee not stand in the assignor's shoes? When may a future right be assigned?

Duties, as well as rights, may be transferred to third parties. Most rights (promises) contained in contracts have corresponding duties (also expressed as promises). Often when an entire contract is assigned, the duties go with it; the transferee is known, with respect to the duties, as the delegatee. The transferor himself does not necessarily escape the duty, however. Moreover, some duties are nondelegable, such as personal promises and those that public policy require to be carried out by a particular official. Without the ability to assign rights and duties, much of the modern economy would grind to a halt.

The parties to a contract are not necessarily the only people who acquire rights or duties under it. One major category of persons acquiring rights is third-party beneficiaries. Only intended beneficiaries acquire rights under the contract, and these are of two types: creditor and donee beneficiaries. The rules for determining whether rights have been conferred are rather straightforward; determining whether rights can subsequently be modified or extinguished is more troublesome. Generally, as long as the contract does not prohibit change and as long as the beneficiary has not relied on the promise, the change may be made.

EXERCISES

1. The Dayton Country Club offered its members various social activities. Some members were entitled, for additional payment, to use the golf course, a coveted amenity. Golfing memberships could not be transferred except upon death or divorce, and there was a long waiting list in this special category; if a person at the top of the list declined, the next in line was eligible. Golfing membership rules were drawn up by a membership committee. Magness and Redman were golfing members. They declared bankruptcy, and the bankruptcy trustee sought, in order to increase the value of their debtors' estates, to assume and sell the golfing memberships to members on the waiting list, other club members, or the general public, provided the persons joined the club. The club asserted that under relevant state law, it was "excused from rendering performance to an entity other than the debtor"—that is, it could not be forced to accept strangers as members. Can these memberships be assigned?
2. Tenant leased premises in Landlord's shopping center, agreeing in the lease "not to assign, mortgage, pledge, or encumber this lease in whole or in part." Under the lease, Tenant was entitled to a construction allowance of up to $11,000 after Tenant made improvements for its uses. Prior to the completion of the improvements, Tenant assigned its right to receive the first $8,000 of the construction allowance to Assignee, who, in turn, provided Tenant $8,000 to finance the construction. Assignee notified Landlord of the assignment, but when the construction was complete, Landlord paid Tenant anyway; when Assignee complained, Landlord pointed to the nonassignment clause. Assignee sued Landlord. Who wins?*Aldana v. Colonial Palms Plaza, Inc.*, 591 So.2d 953 (Fla. Ct. App., 1991).
3. Marian contracted to sell her restaurant to Billings for $400,000. The contract provided that Billings would pay $100,000 and sign a note for the remainder. Billings sold the restaurant to Alice, who agreed to assume responsibility for the balance due on the note held by Marian. But Alice had difficulties and declared bankruptcy. Is Billings still liable on the note to Marian?
4. Yellow Cab contracted with the Birmingham Board of Education to transport physically handicapped students. The contract provided, "Yellow Cab will transport the physically handicapped students of the School System...and furnish all necessary vehicles and personnel and will perform all maintenance and make all repairs to the equipment to keep it in a safe and efficient operating condition at all times."

   Yellow Cab subcontracted with Metro Limousine to provide transportation in connection with its contract with the board. Thereafter, Metro purchased two buses from Yellow Cab to use in transporting the students. DuPont, a Metro employee, was injured when the brakes on the bus that he was driving failed, causing the bus to collide with a tree. DuPont sued Yellow Cab, alleging that under its contract with the board, Yellow Cab had a nondelegable duty to properly maintain the bus so as to keep it in a safe operating condition; that that duty flowed to him as an intended third-party beneficiary of the contract; and that Yellow Cab had breached the contract by failing to properly maintain the bus. Who wins?*DuPont v. Yellow Cab Co. of Birmingham, Inc.*, 565 So.2d 190 (Ala. 1990).

5. Joan hired Groom to attend to her herd of four horses at her summer place in the high desert. The job was too much for Groom, so he told Tony that he (Groom) would pay Tony, who claimed expertise in caring for horses, to take over the job. Tony neglected the horses in hot weather, and one of them needed veterinarian care for dehydration. Is Groom liable?
6. Rensselaer Water Company contracted with the city to provide water for business, domestic, and fire-hydrant purposes. While the contract was in effect, a building caught on fire; the fire spread to Plaintiff's (Moch Co.'s) warehouse, destroying it and its contents. The company knew of the fire but was unable to supply adequate water pressure to put it out. Is the owner of the warehouse able to maintain a claim against the company for the loss?
7. Rusty told Alice that he'd do the necessary overhaul on her classic car for $5,000 during the month of May, and that when the job was done, she should send the money to his son, Jim, as a graduation present. He confirmed the agreement in writing and sent a copy to Jim. Subsequently, Rusty changed his mind. What right has Jim?
8. Fox Brothers agreed to convey to Clayton Canfield Lot 23 together with a one-year option to purchase Lot 24 in a subdivision known as Fox Estates. The agreement contained no prohibitions, restrictions, or limitations against assignments. Canfield paid the $20,000 and took title to Lot 23 and the option to Lot 24. Canfield thereafter assigned his option rights in Lot 24 to the Scotts. When the Scotts wanted to exercise the option, Fox Brothers refused to convey the property to them. The Scotts then brought suit for specific performance. Who wins?
9. Rollins sold Byers, a businessperson, a flatbed truck on a contract; Rollins assigned the contract to Frost, and informed Byers of the assignment. Rollins knew the truck had problems, which he did not reveal to Byers. When the truck needed $3,200 worth of repairs and Rollins couldn't be found, Byers wanted to deduct that amount from payments owed to Frost, but Frost insisted he had a right to payment. Upon investigation, Byers discovered that four other people in the state had experienced similar situations with Rollins and with Frost as Rollins's assignee. What recourse has Byers?
10. Merchants and resort owners in the San Juan Islands in Washington State stocked extra supplies, some perishable, in anticipation of the flood of tourists over Labor Day. They suffered inconvenience and monetary damage due to the union's Labor Day strike of the state ferry system, in violation of its collective bargaining agreement with the state and of a temporary restraining order. The owners sued the union for damages for lost profits, attorney fees, and costs, claiming the union should be liable for intentional interference with contractual relations (the owners' relations with their would-be customers). Do the owners have a cause of action?

SELF-TEST QUESTIONS

1. A creditor beneficiary is
    1. the same as a donee beneficiary
    2. a third-party beneficiary
    3. an incidental beneficiary
    4. none of the above
2. Assignments are not allowed
    1. for rights that will arise from a future contract
    2. when they will materially change the duties that the obligor must perform
    3. where they are forbidden by public policy
    4. for any of the above
3. When an assignor assigns the same interest twice,
    1. the subsequent assignee generally takes precedence
    2. the first assignee generally takes precedence
    3. the first assignee always takes precedence
    4. the assignment violates public policy
4. Factoring
    1. is an example of delegation of duties
    2. involves using an account receivable as collateral for a loan
    3. involves the purchase of a right to receive income from another
    4. is all of the above
5. Personal promises
    1. are always delegable
    2. are generally not delegable
    3. are delegable if not prohibited by public policy
    4. are delegable if not barred by the contract

SELF-TEST AnswerS

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

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14: DISCHARGE OF OBLIGATIONS

Learning Objectives

After reading this chapter, you should understand the following:

1. What is meant by discharge of contract obligations
2. How contract obligations are discharged

14.1: Performance, Discharge, and Defenses to Contract Breach

14.2: Cases

14.3: Summary and Exercises

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14.1: Performance, Discharge, and Defenses to Contract Breach

LEARNING OBJECTIVES

1. To explain the role of conditions in contract law and distinguish among the major types: conditions precedent, subsequent, and concurrent.
2. Understand how performance, partial performance, or no performance may discharge contractual obligations.
3. Understand the rules for “performance to the satisfaction of another."
4. Recognize what rights accrue to the nonbreaching party when the other side announces, before the time for performance, that performance will not be forthcoming—anticipatory breach.

Discharge by Conditions

A **condition** in contract law is a contractual term that creates, limits, or terminates the obligations of the parties depending on the occurrence or nonoccurrence of a specific event. Unlike absolute promises, conditions make a party’s duty to perform contingent. Conditions can be expressly stated in the agreement or implied by law. If the condition is not met, the associated duty may never arise, or it may be discharged.

Contracts do more than simply bind parties to promises. They often include terms that make obligations depend on particular events or circumstances. These terms, known as conditions, play an important role in determining when duties arise, when they are suspended, and when they come to an end. By structuring contracts around conditions, parties can better allocate risks, protect themselves against uncertainty, and ensure that performance occurs only when it makes sense to do so. In the sections that follow, we will explore the major types of conditions and how they operate within the broader framework of contract law.

Condition Precedent

A **condition precedent** is an event that must occur before a party’s duty to perform under a contract arises. If the condition does not occur, no duty ever arises.

Example – Real Estate Financing Contingency

In most real estate purchase agreements, the buyer’s obligation to buy is subject to securing financing (a mortgage loan).

- **Scenario:** A buyer agrees to purchase a home for $500,000, but the contract states the obligation to purchase is *“contingent upon Buyer obtaining financing from a bank for at least 80% of the purchase price.”*
- **Application:** The buyer has no duty to complete the purchase until the financing condition is met. If the buyer cannot secure financing, the contract is terminated without breach.

Why it’s a condition precedent: The buyer’s duty to perform (pay the purchase price) does not arise until after the condition (obtaining financing) is fulfilled.

Other Common Real Examples:

1. **Insurance Contracts:** Coverage begins only after the insured pays the first premium — payment is a condition precedent.
2. **Employment Contracts:** A job offer might state that employment begins *only if* the applicant passes a background check or drug test.
3. **Construction Contracts:** Payment to a subcontractor may be conditioned on the general contractor first receiving payment from the project owner.

Condition Subsequent

A **condition subsequent** is an event that occurs after a duty has arisen, which, if it happens, discharges the duty and excuses further performance. Unlike a **condition precedent** (which must occur before a duty begins), a condition subsequent can cut off an existing contractual obligation.

Example – Cal Poly Pomona Kellogg Arabian Horse Center

W. K. Kellogg, the cereal magnate, established the Arabian Horse Ranch in Pomona, California. He later deeded the ranch to the State of California with a **condition subsequent**: the state must continue the Arabian horse breeding program. If the program was discontinued, ownership of the land and ranch would revert to the W. K. Kellogg Foundation.

- **Application:** The State of California had a present duty (maintaining the horse program), but if the condition subsequent (failure to continue the program) occurred, the Foundation could reclaim ownership.
- **Why it's a condition subsequent:** The obligation already existed (the state owned and managed the ranch), but it could be cut short by the occurrence of a later event (stopping the Arabian horse program).

Comparison:

- **Condition precedent:** "I will sell you my horse if it passes a veterinary exam." (Duty arises only after the exam.)
- **Condition subsequent:** "You can keep the ranch as long as you maintain the horse program." (Duty exists now but can be terminated if the program stops.)

Condition Concurrent

A **condition concurrent** occurs when the duties of both parties are to be performed at the same time. Each party's duty is conditional on the other's performance. If one party is unwilling or unable to perform, the other party's duty is discharged.

Classic Scenario – Real Estate Closing

- **Facts:** A buyer agrees to purchase a home for $500,000. The contract states that the buyer will pay the purchase price *upon delivery of the deed* from the seller.
- **Application:** The buyer's duty to pay and the seller's duty to transfer title are concurrent conditions — they occur simultaneously at closing.
  - If the seller shows up ready to transfer title but the buyer does not tender payment, the buyer is in breach.
  - If the buyer tenders payment but the seller refuses to convey title, the seller is in breach.
  - If neither party performs, neither can enforce the contract.

Other Examples

1. **Sale of Goods (UCC § 2-507):**
   - The seller's duty to deliver goods and the buyer's duty to pay are concurrent conditions, unless otherwise agreed.
   - Example: A farmer sells a truckload of oranges at the market. The farmer must deliver the oranges when the buyer tenders payment; the buyer must pay when the oranges are delivered.
2. **Employment & Payment:**
   - In some jobs, an employee agrees to work for a day in exchange for payment at the end of the day.
   - The employee's duty to work and the employer's duty to pay are concurrent — each is conditional on the other's performance.
3. **Service Contracts:**
   - A wedding photographer delivers edited photos only when final payment is received. Payment and delivery happen together — concurrent conditions.

Discharge by Performance (or Nonperformance) of the Duty

Introduction Scenario

Imagine this: Sarah hires BuildWell Contractors to construct a custom guesthouse in her backyard for $150,000. The contract specifies a completion date of July 1, the use of high-grade materials, and installation of custom windows. Both Sarah and BuildWell understand that time and quality are critical.

As the project unfolds, different issues arise. BuildWell finishes most of the project but substitutes a different brand of windows. Later, disputes emerge over timing and payment. This scenario illustrates how contracts may be discharged by **performance** (when duties are met) or by **nonperformance** (when one party materially fails to do what was promised).

The modern trend at common law—and explicitly under the Uniform Commercial Code (UCC) § 1-203—is that both parties owe each other a duty of **good faith**. Every contract carries an implied covenant that parties will act honestly, deal fairly, and not frustrate the other's reasonable expectations. With that in mind, let's examine how performance (or its absence) discharges a contract.

Complete Performance

Definition:
Complete performance occurs when a party fulfills all contractual obligations exactly as specified in the agreement.

Legal Effect:

1. The performing party is entitled to full payment or the return performance promised in the contract.
2. The other party cannot withhold performance or claim breach.
3. Courts rarely intervene in disputes involving complete performance, since both sides have received the full benefit of the bargain.

Scenario Application:
If BuildWell completes Sarah's guesthouse exactly as agreed—using the specified materials, finishing by July 1, and installing the custom windows—Sarah must pay the full contract price.

Other Examples:

- A landscaper installs 10 rose bushes and 5 palm trees exactly by the contract date.
- A tailor delivers a custom suit in the correct fabric, style, and size.

Business Note: Complete performance is ideal, though uncommon in complex projects.

Substantial Performance

Definition:
Substantial performance means that the essential purpose of the contract has been met, even if some minor details differ from the precise terms.

Legal Effect:

1. The performing party is entitled to payment, but the other party may deduct or recover damages for deficiencies.
2. Prevents minor deviations from being treated as a material breach.

Scenario Application:
BuildWell completes Sarah's guesthouse on time and to specification, but installs a different brand of windows of equal quality. This would likely qualify as substantial performance. Sarah must pay the contract price but may recover damages equal to the cost difference (if any).

Other Examples:

- A software developer delivers a program that meets all functional requirements, but the font style is slightly different.
- A painter finishes painting a house but uses a similar shade of blue instead of the exact one specified.

Limits: If the defect defeats the central purpose (e.g., BuildWell substitutes wood beams for steel beams), this is not substantial performance but a material breach.

Breach of Contract

Definition:
A breach occurs when one party fails to perform a contractual duty as promised, without a valid excuse.

Types of Breach:

1. **Material Breach**
   - **Definition:** Failure that defeats the central purpose of the contract.
   - **Scenario Application:** If BuildWell uses cheap wood instead of the specified high-grade steel beams, Sarah has been denied the core benefit. She may terminate the contract and sue for damages.
2. **Minor (Partial) Breach**
   - **Definition:** A slight deviation that does not destroy the contract's purpose.
   - **Scenario Application:** If BuildWell finishes Sarah's guesthouse two days late but otherwise meets the contract, Sarah must still pay, though she may recover damages caused by the delay.
3. **Anticipatory Breach (Repudiation)**
   - **Definition:** Occurs when one party clearly indicates before performance is due that they will not perform.
   - **Scenario Application:** If BuildWell emails Sarah a month before July 1 saying they will not finish the guesthouse, Sarah can immediately treat the contract as breached and sue, or wait until July 1 to see if BuildWell performs.

Common Law Standards: Substantial Performance

At common law, complete performance is the rule. But courts developed the **substantial performance doctrine** to avoid harsh results:

- If a party performs nearly all obligations in good faith, minor deviations won't constitute a material breach.
- The other party must still perform but may recover damages for imperfections.

Case Example: *Jacob & Youngs, Inc. v. Kent* (N.Y. 1921): A contractor used a different brand of pipe than specified, but of equal quality. The court ruled this was substantial performance. The homeowner had to pay, though he could recover damages for the cost difference.

Contracts Requiring Performance to the Standard of Satisfaction

Some contracts condition performance on one party's satisfaction with the work. These are often called **"satisfaction contracts."** Courts apply either a **subjective** or **objective** standard, depending on the nature of the agreement.

1. Subjective Standard – Matters of Personal Taste

Used when the contract involves personal preference, aesthetics, or artistic judgment.

- **Examples:** Portrait commissions, custom-tailored clothing, or a musical performance for a private event.
- **Legal Rule:** The party may reject the work if not personally satisfied—so long as they act in good faith, not simply to escape obligations.

2. Objective Standard – Reasonable Person Test

Used when performance can be measured against industry standards of quality or utility.

- **Examples:** Construction of a commercial building, installation of machinery, or professional services.
- **Legal Rule:** The test is whether a reasonable person would be satisfied, not whether the individual party claims dissatisfaction.

3. Mixed Applications

Some agreements combine subjective and objective elements.

- **Example:** A custom home contract may involve subjective taste (design, finishes) but also objective standards (structural integrity, safety).
- **Rule of Thumb:** Courts favor the **reasonable person test** unless the contract clearly indicates the parties intended a personal satisfaction standard.

Key Points

- **Material breach** → goes to the core of the contract; allows termination and damages.
- **Minor breach** → smaller deviation; damages available, but the contract remains enforceable.
- **Anticipatory breach** → refusal to perform before performance is due; non-breaching party may sue immediately.
- **Substantial performance** → good-faith completion of essential duties prevents a finding of material breach, though damages may still apply.
- **Satisfaction contracts** → apply either a subjective standard (personal taste) or an objective standard (reasonable person test), depending on the contract's nature.

Discharge by Agreement of the Parties

Mutual Rescission

Sometimes the easiest way to end a contract is for **both parties to agree to let it go**. This is called **mutual rescission**. In rescission, each party gives up their duties to perform, and the contract is treated as if it never existed.

How It Works

- **Formal Release:** The parties can sign a written agreement saying the duty is discharged.
- **Condition Met:** The parties may agree that the obligation ends when a certain condition happens.
- **Agreement Not to Sue:** Sometimes one party agrees not to sue, which also ends the obligation.

The Restatement (Second) of Contracts §283 recognizes that an agreement to rescind is valid **even if performance has already started** or if one party has a partial claim for breach.

Example

Andy agrees to mow Anne's lawn. He starts the job, but it's unbearably hot. Andy says, *"Why don't we just forget the whole thing?"* Anne agrees.

- Andy no longer has to finish mowing.
- Anne no longer has to pay, even for the partial work done.
  Their mutual agreement cancels the contract.

Actions Speak Louder than Words

An agreement to rescind does **not always need to be in writing**—or even spoken. If both parties act like the contract no longer matters (for example, neither tries to perform or enforce it), the law may treat it as rescinded.

Real-World Business Practice

In the business world, contracts are often called "orders." If a buyer cancels an order, many sellers simply accept the cancellation without demanding damages—even though, legally, that could be considered a breach.

- Businesspeople often see cancellation as part of normal buyer-seller relationships.
- Why? Because long-term relationships matter more than fighting over one order.
- A famous study by sociologist Stewart Macaulay (1963) found that most businesses routinely accept cancellations rather than suing for breach.

Important Legal Note

Under the **UCC §2-720**, using words like "cancellation" or "rescission" does not automatically wipe out the right to sue for a past breach. If the parties want to completely release each other from **all obligations (past and future)**, they must say so clearly.

Still, courts will often look at actions as much as words. If both parties walk away and stop enforcing their rights, that behavior itself can amount to rescission.

Waiver

A second way a contract duty can be discharged is through a **waiver**. A **waiver** happens when one party voluntarily gives up a specific right under the contract—but not the entire right to performance. In other words, the contract still exists, but one side has agreed to allow a deviation from its strict terms.

Example: Waiver of Timely Payment

Imagine this situation:

- Tenant's lease requires rent to be paid on the **first of every month**.
- Tenant's employer pays him on the **tenth**, so Tenant pays rent late every month.
- Landlady accepts the late payments without objection.

By doing this, Landlady has **waived her right** to demand rent strictly on the first of the month—**unless** the lease contains a clause that says accepting late payments does not create a waiver.

Waiver vs. Release

- **Waiver** = permission to deviate from part of the contract.
  - Example: Landlady allows Tenant to pay on the 10th instead of the 1st.
- **Release** = letting go of the entire obligation.
  - Example: Landlady tells Tenant he doesn't have to pay rent at all for the month.

Legal Note

Courts generally hold parties to their actions. If you repeatedly accept a deviation without objection, the law may say you waived your right to enforce strict compliance. However, many contracts include **nonwaiver provisions** stating that acceptance of late or partial performance does not mean a permanent waiver.

Discharge by Novation

We first encountered **novation** in the discussion of **third-party rights**, where it arises when an obligee agrees to accept a new party in place of the original obligor. It is worth revisiting here, because novation is also an important way that contracts may be **discharged**.

Elements of a Novation

For a novation to be valid, four things are usually required:

1. A **previous valid contract** exists.
2. All parties agree to a **new contract**.
3. The new contract replaces the old one and discharges it.
4. The new contract is valid and enforceable.

Example 1: New Party

- Alex owes $5,000 to Jordan.
- With everyone's consent, Taylor agrees to take Alex's place and pay Jordan the $5,000.
- This substitution of Taylor for Alex is a novation. Alex is released from the obligation, and Jordan must now look to Taylor for payment.

Example 2: New Contract

- A construction company contracts to build a deck for a homeowner.
- Later, both sides agree to cancel the deck contract and instead enter into a new agreement for a patio.
- The new patio contract replaces the old deck contract. The old obligation is discharged by novation.

Novation vs. Assignment

- **Novation** = the old party is fully released, and the new party takes on the obligation.
- **Assignment** = rights or duties are transferred, but the original party may still remain liable unless the other party agrees to a novation.

Accord and Satisfaction

A contract duty may also be discharged through an **accord and satisfaction**. This happens when the parties agree to accept something different—usually less—than what was originally owed.

- The **accord** is the new agreement that changes the original obligation.

- The **satisfaction** is the performance of that new agreement.
  Once the satisfaction is completed, the original duty is discharged.

Example: Debt Settlement

- Jordan owes Casey **$1,000** on a loan.
- They agree (the **accord**) that Casey will accept **$700** as full payment.
- When Jordan pays the $700 (the **satisfaction**), the original $1,000 debt is discharged.

If Jordan never pays the $700, then Casey can still sue for the full $1,000 under the original contract, unless the accord was properly structured.

Accord and Satisfaction in Business

Accord and satisfaction is common in situations involving disputes over debt or performance:

- A supplier delivers goods, but the buyer claims they are defective. The buyer offers to pay part of the invoice, and the supplier accepts.
- A customer writes “payment in full” on a check for less than the billed amount. If the business cashes the check, courts may treat that as an accord and satisfaction.

Accord vs. Novation

- **Accord and Satisfaction:** The original obligation is replaced only when the new agreement is performed (satisfaction).
- **Novation:** The original contract is immediately replaced by a new one, with or without new parties.

Defenses to Contract Breach

Even when one party fails to perform a contract, it does not always mean they will be held legally liable for breach. Contract law recognizes that sometimes circumstances change in ways no one could reasonably anticipate. These situations may excuse nonperformance. Collectively, these are known as **defenses to breach of contract**.

Defenses prevent unfairness when performance is literally impossible, commercially unreasonable, or when the contract’s purpose has been destroyed. Below are the major defenses recognized in modern contract law.

Impossibility of Performance

Definition: Performance is excused when it becomes **literally impossible** to carry out the contract due to circumstances **beyond the parties’ control**.

1) When Impossibility Applies (Objective Impossibility)

It must be impossible for **anyone** to perform—not just harder or more expensive for this promisor.

- **Destruction of identified subject matter**
  If the specific thing the contract relies on is destroyed without fault, duties tied to it are discharged.
  Examples: A unique concert hall burns down; a one-of-a-kind painting promised for sale is accidentally destroyed.
  (See Restatement (Second) §263; UCC §2-613 for identified goods.)

- **Death or incapacity in personal-services contracts**
  When the promised performance depends on a particular person’s unique skill, their death or incapacity excuses performance.
  (Restatement §262.)

- **Supervening illegality / government order**
  A later law or official order that makes performance illegal excuses performance from that point forward.
  (Restatement §264.)

- **Failure or destruction of an essential, non-substitutable means of performance**
  If the contract assumes a particular irreplaceable method or thing (not just a preferred one) and it’s destroyed, duties may be discharged.

- **Temporary vs. permanent impossibility**
  - *Temporary* impossibility suspends performance until the barrier ends, unless delay defeats the contract’s purpose.
  - *Permanent* impossibility discharges the duty.

2) When Impossibility Does Not Apply (Subjective Impossibility)

Courts reject "it's too hard for me" defenses.

- **Mere increased cost, difficulty, or market shifts** (even severe), standing alone.
- **Financial inability** (can't get financing, cash-flow problems).
- **Foreseeable hurdles** the promisor assumed (seasonal storms, ordinary labor shortages) unless the contract says otherwise.
- **Self-induced impossibility** (promisor's own fault or voluntary acts).

> **Contrast:** If performance hasn't become literally impossible but has become **extraordinarily** burdensome and unforeseen, consider **Commercial Impracticability** (UCC §2-615) instead.

3) Risk Allocation and Contract Terms

- **Force majeure clauses** often list excusing events (e.g., "acts of God," war, embargoes, pandemics), set **notice** deadlines, and may require **best efforts** to overcome the impediment. They can **expand or narrow** the default impossibility rules.
- **Assumption of risk:** If the contract clearly puts a risk on one party (fixed-price despite supply risk), impossibility is less likely to apply.

4) Legal Consequences of Impossibility

- **Duty discharged** for the affected performance (no breach).
- **Restitution/quantum meruit:** A party who conferred benefits before impossibility may recover the reasonable value of those benefits. *(Restatement §272.)*
- **Partial impossibility:** Courts may **apportion** duties; the unaffected parts may remain enforceable.
- **Notice:** Good faith requires **prompt notice** of the impediment; under the UCC, notice must be **seasonable** (§2-615).

5) Illustrative Examples

- **Applies:**
  - *Music venue destroyed:* A band's contract to perform at a named hall is discharged when the hall burns down the day before the show.
  - *Identified goods casualty:* A gallery sells "Picasso Sketch #47" (that specific piece). A burst pipe destroys it pre-delivery; seller's duty to deliver is discharged (§2-613).
  - *Export embargo:* A new government embargo outlaws shipping the contracted goods to the buyer's country; performance is excused from the embargo forward.
- **Does Not Apply:**
  - *Price spike:* Input costs triple because of market turmoil—still possible to perform, just costly.
  - *Supplier fails you:* Your chosen subcontractor backs out, but alternatives exist; you must find substitutes unless the contract made that supplier essential.
  - *Financing falls through:* Your lender withdraws; payment duty usually remains unless the contract made financing a true condition.

Commercial Impracticability

Definition:
Under the **UCC (§2-615)** and common law, performance may be excused if it becomes **extraordinarily difficult, risky, or expensive** in a way that was **unforeseeable** when the contract was made. This doctrine is less strict than **impossibility** (which requires literal impossibility), but more demanding than mere inconvenience or increased costs.

1) When It Applies

To claim commercial impracticability, courts generally require:

1. **Unforeseen event** – Something occurred that the parties could not have reasonably anticipated.

2. **Basic assumption** – The nonoccurrence of that event was a fundamental assumption of the contract.
3. **Extreme burden** – The event made performance excessively costly or difficult, beyond what the parties expected.
4. **No fault** – The event was not caused by the party seeking excuse.
5. **No risk allocation** – The contract did not place the risk of that event on the party seeking excuse.

2) Examples of Impracticability Events

- **War or embargo** disrupting shipping routes.
- **Natural disasters** (earthquakes, hurricanes) wiping out supply chains.
- **Unforeseen shortages** caused by global crises.
- **Government regulations or bans** making certain inputs unobtainable.

3) When It Does *Not* Apply

Courts apply this defense narrowly. It does **not** excuse performance when:

- Only **ordinary cost increases** or delays occur.
- The risk was **foreseeable** and not addressed in the contract.
- The party claiming impracticability contributed to the problem.
- Substitute performance is available, even if less profitable.

Example: If fuel prices rise 40% after a trucking contract is signed, the carrier cannot claim impracticability—market shifts are foreseeable.

4) UCC §2-615 (Sales of Goods)

This section provides that a seller is excused from timely delivery of goods if:

- Performance has become impracticable due to an unforeseen event; and
- The seller seasonably notifies the buyer of the delay or nondelivery.

The seller must also **allocate production fairly** if only part of the capacity is affected (e.g., rationing available goods among customers).

5) Famous Case Example

Mineral Park Land Co. v. Howard (Cal. 1916):
A contractor agreed to remove gravel from a riverbed. Most of the gravel was underwater and could only be extracted at ten times the normal cost. The court held that the duty was discharged because performance was impracticable, not just inconvenient.

6) Commercial Impracticability vs. Impossibility

- **Impossibility:** No one can perform (e.g., a building burns down).
- **Commercial Impracticability:** Performance is possible, but only at an extreme and unreasonable cost or risk (e.g., blocked shipping routes raising cost 500%).

7) Example Recap

A supplier agrees to deliver steel at a fixed price. War breaks out, shipping routes close, and costs rise 500%. Because the burden is extreme, unforeseeable, and not allocated to the supplier in the contract, a court may excuse performance under commercial impracticability.

Frustration of Purpose

Definition:
Frustration of purpose occurs when an **unforeseen event** destroys the contract's **central reason for existence**, even though performance is still technically possible. The parties could carry out their promises, but doing so would no longer achieve the purpose they both intended.

1) When It Applies

For frustration of purpose to excuse performance, courts usually require:

1. **Principal purpose known to both parties** – The contract's main reason must have been clear to both sides at the time of contracting.
2. **Substantial frustration** – The event must nearly eliminate the value of performance, not just reduce it.
3. **Unforeseen event** – The frustrating event could not reasonably have been anticipated.
4. **No fault** – The frustrating event must not be caused by the party claiming the defense.

2) Key Characteristics

- Unlike **impossibility**, the performance itself is still possible.
- Unlike **commercial impracticability**, the burden is not necessarily higher in cost—rather, the value or purpose of the contract has disappeared.
- Courts apply this defense **narrowly**, because parties generally assume some risks when entering a contract.

3) Classic Case Example

Krell v. Henry (1903, England):

- Facts: Henry rented a flat along the coronation parade route of King Edward VII. The king fell ill, and the parade was cancelled.
- Result: Henry was excused from paying rent because the sole purpose—viewing the coronation—was destroyed.
- Significance: The apartment could still be occupied, but its intended use was frustrated.

4) Other Illustrations

- **Sports event cancellation:** A fan buys a hospitality suite to watch the World Cup final. The match is cancelled due to a natural disaster. The suite still exists, but the purpose of attending the game is gone.
- **Commercial leases during government shutdowns:** A restaurant leases space in a stadium, but the season is cancelled. The leasehold still exists, but the purpose of selling food to event-goers is destroyed.
- **Special-purpose contracts:** A florist contracts to provide elaborate arrangements for a parade that is later cancelled. Supplying the flowers is still possible, but the event that gave the contract meaning no longer exists.

5) When It Does *Not* Apply

Frustration of purpose will not excuse performance when:

- The event merely reduces profitability but does not destroy the contract's purpose.
- The frustrating event was foreseeable but ignored when drafting the contract.
- The party claiming frustration could still gain some substantial value from the agreement.

Example: A tenant who rents office space cannot claim frustration simply because business profits decline. The basic purpose (having space to operate) still exists.

6) Comparison with Related Doctrines

- **Impossibility:** Performance is objectively impossible (e.g., subject matter destroyed).
- **Commercial Impracticability:** Performance is possible but only at extreme/unforeseen cost.
- **Frustration of Purpose:** Performance is possible, but pointless because the purpose has vanished.

7) Example Recap

A man rents an apartment solely to watch a coronation parade. The parade is cancelled. The apartment can still be used, but the main purpose of the contract is gone. Courts excuse the renter under frustration of purpose.

Other Methods of Discharge

Statute of Limitations

When an obligor has breached a contract, the obligee has the right to sue in court for a remedy. But that right does not last forever. Every state has statutes of limitations that establish time periods within which the suit must be brought (different time periods are spelled out for different types of legal wrongs: contract breach, various types of torts, and so on). The time period for contract actions under most statutes of limitations ranges between two and six years.

The **Uniform Commercial Code (UCC) § 2-725** sets a time limit for bringing lawsuits based on contracts for the sale of goods. This is known as the **statute of limitations**.

- **General Rule:** An action for breach of any sales contract must be commenced within **four years** after the cause of action accrues.
- **Accrual:** A cause of action "accrues" (begins to run) when the breach occurs—not when the injured party discovers the breach.
  - *Example:* If a seller delivers defective goods on June 1, the statute begins running on that date, even if the buyer does not notice the defect until months later.
- **Modification:** The parties may reduce the period to **not less than one year** by agreement, but they cannot extend it beyond four years.
- **Warranty Claims:** In cases involving warranties, the four-year period begins when tender of delivery is made, even if the defect is not discovered until later—unless the warranty explicitly extends to future performance.

Bankruptcy

Under the federal bankruptcy laws certain obligations are discharged once a court declares a debtor to be bankrupt. The law spells out the particular types of debts that are canceled upon bankruptcy.

KEY TAKEAWAY

Contracts may be discharged by conditions, performance, nonperformance, or agreement. Conditions define when duties arise or end: precedents (duty arises after event), subsequents (duty ends if event occurs), or concurrents (duties performed at the same time). Performance can be complete (full payment owed), substantial (minor defects with damages), or breached—material (excuses other party), minor (damages but contract continues), or anticipatory (refusal before due). Parties may also discharge obligations by mutual rescission, waiver, novation, or accord and satisfaction. Together, these rules balance fairness and predictability in enforcing contracts.

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14.2: Cases

Substantial Performance; Conditions Precedent

TA Operating Corp. v. Solar Applications Engineering, Inc.

191 S.W.3d 173 (Tex. Ct. App. 2005)

TA Operating Corporation, a truck stop travel center company, contracted with Solar Applications Engineering, Inc. to construct a prototype multi-use truck stop in San Antonio for a fixed price of $3,543,233....

[When the project was near] completion, TA sent Solar a "punch list" of items that needed to be finished to complete the building. Solar disputed several items on the list and delivered a response to TA listing the items Solar would correct....Solar began work on the punch list items and filed a lien affidavit [a property that carries a lien can be forced into sale by the creditor in order to collect what is owed] against the project on October 2, 2000 in the amount of $472,392.77. TA understood the lien affidavit to be a request for final payment.

On October 18, 2000, TA sent notice to Solar that Solar was in default for not completing the punch list items, and for failing to keep the project free of liens. TA stated in the letter that Solar was not entitled to final payment until it completed the remainder of the punch list items and provided documentation that liens filed against the project had been paid....Solar acknowledged at least two items on the punch list had not been completed, and submitted a final application for payment in the amount of $472,148,77....TA refused to make final payment, however, contending that Solar had not complied with section 14.07 of the contract, which expressly made submission of a [lien-release] affidavit a condition precedent to final payment:...

The final Application for Payment shall be accompanied by:...complete and legally effective releases or waivers...of all lien rights arising out of or liens filed in connection with the work.

Although Solar did not comply with this condition precedent to final payment, Solar sued TA for breach of contract under the theory of substantial performance....TA [asserts that] the doctrine of substantial performance does not excuse Solar's failure to comply with an express condition precedent to final payment....

The first issue we must resolve is whether the doctrine of substantial performance excuses the breach of an express condition precedent to final payment that is unrelated to completion of the building. TA acknowledges that Solar substantially performed its work on the project, but contends its duty to pay was not triggered until Solar pleaded or proved it provided TA with documentation of complete and legally effective releases or waivers of all liens filed against the project....TA contends that when the parties have expressly conditioned final payment on submission of [a liens-release] affidavit, the owner's duty to pay is not triggered until the contractor pleads or proves it complied with the condition precedent.

Solar contends that although it did not submit [a liens-release] affidavit in accordance with the contract, it may still recover under the contract pursuant to the substantial performance doctrine. Solar argues that to hold otherwise would bring back the common law tradition that the only way for a contractor to recover under a contract is full, literal performance of the contract's terms....

While the common law did at one time require strict compliance with the terms of a contract, this rule has been modified for building or construction contracts by the doctrine of substantial performance. "Substantial performance" was defined by the Texas [court] in [Citation]:

To constitute substantial compliance the contractor must have in good faith intended to comply with the contract, and shall have substantially done so in the sense that the defects are not pervasive, do not constitute a deviation from the general plan contemplated for the work, and are not so essential that the object of the parties in making the contract and its purpose cannot without difficulty, be accomplished by remedying them. Such performance permits only such omissions or deviation from the contract as are inadvertent and unintentional, are not due to bad faith, do not impair the structure as a whole, and are remediable without doing material damage to other parts of the building in tearing down and reconstructing.

...The doctrine of substantial performance recognizes that the contractor has not completed construction, and therefore is in breach of the contract. Under the doctrine, however, the owner cannot use the contractor's failure to complete the work as an excuse for non-payment. "By reason of this rule a contractor who has in good faith substantially performed a building contract is

permitted to sue under the contract, substantial performance being regarded as full performance, so far as a condition precedent to a right to recover thereunder is concerned." [Citation]...

Solar argues that by agreeing substantial performance occurred, TA acknowledged that Solar was in "full compliance" with the contract and any express conditions to final payment did not have to be met. [Citation]: "[a] finding that a contract has been substantially completed is the legal equivalent of full compliance, less any offsets for remediable defects." Solar argues that TA may not expressly provide for substantial performance in its contract and also insist on strict compliance with the conditions precedent to final payment. We disagree. While the substantial performance doctrine permits contractors to sue under the contract, it does not ordinarily excuse the non-occurrence of an express condition precedent:

The general acceptance of the doctrine of substantial performance does not mean that the parties may not expressly contract for literal performance of the contract terms....Stated otherwise, if the terms of an agreement make full or strict performance an express condition precedent to recovery, then substantial performance will not be sufficient to enable recovery under the contract.

15 Williston on Contracts § 44.53 (4th Ed.2000) (citing Restatement (Second) of Contracts, § 237, cmt. d (1981))....

TA, seeking protection from double liability and title problems, expressly conditioned final payment on Solar's submission of a [liens-release] affidavit. Solar did not dispute that it was contractually obligated to submit the affidavit as a condition precedent to final payment, and it was undisputed at trial that $246,627.82 in liens had been filed against the project. Though the doctrine of substantial performance permitted Solar to sue under the contract, Solar did not plead or prove that it complied with the express condition precedent to final payment. Had Solar done so, it would have been proper to award Solar the contract balance minus the cost of remediable defects. While we recognize the harsh results occasioned from Solar's failure to perform this express condition precedent, we recognize that parties are free to contract as they choose and may protect themselves from liability by requesting literal performance of their conditions for final payment....

[T]he trial court erred in awarding Solar the contract balance [as] damages, and we render judgment that Solar take nothing on its breach of contract claim.

CASE QUESTIONS

1. Why did Solar believe it was entitled to the contract balance here?
2. Why did the court determine that Solar should not have been awarded the contract damages that it claimed, even though it substantially complied?
3. How has the common law changed in regard to demanding strict compliance with a contract?

Waiver of Contract Rights; Nonwaiver Provisions

Minor v. Chase Auto Finance Corporation

—S.W.3d——, 2010 WL 2006401 (Ark. 2010)

Sheffield, J.

We have been asked to determine whether non-waiver and no-unwritten-modifications clauses in a [contract] preclude a creditor from waiving future strict compliance with the agreement by accepting late payments....

Appellant Mose Minor (Minor) entered into a Simple Interest Motor Vehicle Contract and Security Agreement with Appellee Chase Auto Finance Corporation (Chase) to finance the purchase of a 2003 Toyota Tundra. By the terms of the agreement, Minor was to make sixty-six payments of $456.99 on the fourteenth of each month....The agreement also included the following relevant provisions:

G. Default: If you...default in the performance of any promise you make in this contract or any other contract you have with us, including, but not limited to, failing to make any payments when due, or become insolvent, or file any proceeding under the U.S. Bankruptcy Code,...we may at our option and without notice or demand (1) declare all unpaid sums immediately due and payable subject to any right of reinstatement as required by law (2) file suit against you for all unpaid sums (3) take immediate possession of the vehicle (4) exercise any other legal or equitable remedy....Our remedies are cumulative and taking of any action shall not be a waiver or prohibit us from pursuing any other remedy. You agree that upon your default we shall be entitled to recover from you our reasonable collection costs, including, but not limited to, any attorney's fee. In addition, if we repossess the vehicle, you grant

to us and our agents permission to enter upon any premises where the vehicle is located. Any repossession will be performed peacefully....

J. Other Agreements of Buyer:...(2) You agree that if we accept moneys in sums less than those due or make extensions of due dates of payments under this contract, doing so will not be a waiver of any later right to enforce the contract terms as written....(12) All of the agreements between us and you are set forth in this contract and no modification of this contract shall be valid unless it is made in writing and signed by you and us....

K. Delay in Enforcement: We can delay or waive enforcement of any of our rights under this contract without losing them.

Minor's first payment was late, as were several subsequent payments. At times he failed to make any payment for months. Chase charged a late fee for each late payment, and sent several letters requesting payment and offering to assist Minor with his account. Chase also warned Minor that continued failure to make payments would result in Chase exercising its legal options available under the agreement, including repossession of the vehicle....At one point, Minor fell so far behind in his payments that Chase was on the verge of repossessing the vehicle. However...the parties agreed to a two-month extension of the agreement....The extension agreement indicated that all other terms and conditions of the original contract would remain the same.

On November 2, 2004, Minor filed for Chapter 7 "Introduction to Tort Law" bankruptcy [after which] Chase sent Minor a letter acknowledging that Minor's debt to Chase had been discharged in bankruptcy. The letter further stated that Chase still had a valid lien on the vehicle, and if Minor wished to keep the vehicle, he would have to continue to make payments to Chase. Otherwise, Chase would repossess the vehicle....

On September 28, 2006, a repossession agent...arrived at Minor's home some time in the afternoon to repossess the vehicle....[Notwithstanding Minor's insistence that the agent stop] the agent removed Minor's possessions from the vehicle and towed it away. Chase sold the vehicle. The amount of the purchase price was reflected on Minor's account....

On January 7, 2008, Minor filed a complaint against Chase [alleging] that, during the course of the contract, the parties had altered the provisions of the contract regarding Chase's right to repossess the vehicle and Chase had waived the right to strictly enforce the repossession clause. Minor further claimed that the repossession agent committed trespass and repossessed the vehicle forcibly, without Minor's permission, and through trickery and deceit, in violation of [state law]. Also, Minor asserted that he was not in default on his payments, pursuant to the repayment schedule, at the time Chase authorized repossession. Therefore, according to Minor, Chase committed conversion, and breached the Arkansas Deceptive Trade Practices Act [Citation], and enhanced by Arkansas Code Annotated section 4-88-202, because Minor is an elderly person. Minor sought compensatory and punitive damages....

After hearing these arguments, the circuit court ruled that Minor had presented no evidence that the conduct of Chase or the repossession agent constituted grounds for punitive damages; that by the express terms of the contract Chase's acceptance of late payments did not effect a waiver of its rights in the future; that at the time of repossession, Minor was behind in his payments and in breach of the contract; that Chase had the right under the contract to repossess the vehicle and did not commit conversion; and that there was no evidence to support a claim that Chase had violated the Arkansas Deceptive Trade Practices Act....

[W]e affirm our previous decisions that when a contract does not contain a non-waiver and a no-unwritten-modification provision and the creditor has established a course of dealing in accepting late payments from the debtor, the creditor waives its right to insist on strict compliance with the contract and must give notice to the debtor that it will no longer accept late payments before it can declare default of the debt. However, we announce today that, if a contract includes non-waiver and no-unwritten-modification clauses, the creditor, in accepting late payments, does not waive its right under the contract to declare default of the debt, and need not give notice that it will enforce that right in the event of future late payments....

In arriving at this conclusion, we adhere to the principle that "a [contract] is effective according to its terms between the parties."...We have long held that non-waiver clauses are legal and valid. *See* [Citations] Also, [the Arkansas UCC 2-209(2)] declares that no-unwritten-modification provisions are binding.

We acknowledge that there is a difference of opinion amongst the courts in other jurisdictions over the effect of non-waiver and no-unwritten-modification clauses....

We concur with the Supreme Court of Indiana's decision in [Citation], that a rule providing that non-waiver clauses could themselves be waived by the acceptance of late payments is "illogical, since the very conduct which the [non-waiver] clause is designed to permit[,] acceptance of late payment[,] is turned around to constitute waiver of the clause permitting the conduct." We also agree that the approach of jurisdictions that require creditors who have accepted late payments in the past to notify

debtors that they expect strict compliance in the future, despite the existence of a non-waiver provision in the contract, is not "sound." Such a rule, we recognize, "begs the question of validity of the non-waiver clause." Finally, our holding is in line with the Indiana Supreme Court's ruling that it would enforce the provisions of the contract, since the parties had agreed to them, and that it would not require the creditor to give notice, because the non-waiver clause placed the [creditor] in the same position as one who had never accepted a late payment. [Citations]...

Certified question answered; remanded to court of appeals.

CASE QUESTIONS

1. What is a nonwaiver clause?
2. Why did Mose think his late payments were not grounds for repossession of his truck?
3. Why would a creditor accept late payments instead of immediately repossessing the collateral?
4. Why did Mose lose?

Impossibility as a Defense

Parker v. Arthur Murray, Inc.

295 N.E.2d 487 (Ill. Ct. App. 1973)

Stamos, J.

The operative facts are not in dispute. In November, 1959 plaintiff went to the Arthur Murray Studio in Oak Park to redeem a certificate entitling him to three free dancing lessons. At that time he was a 37 year-old college-educated bachelor who lived alone in a one-room attic apartment in Berwyn, Illinois. During the free lessons the instructor told plaintiff he had 'exceptional potential to be a fine and accomplished dancer' and generally encouraged further participation. Plaintiff thereupon signed a contract for 75 hours of lessons at a cost of $1000. At the bottom of the contract were the bold-type words, 'NON-CANCELABLE, NEGOTIABLE CONTRACT.' This initial encounter set the pattern for the future relationship between the parties. Plaintiff attended lessons regularly. He was praised and encouraged regularly by the instructors, despite his lack of progress. Contract extensions and new contracts for additional instructional hours were executed. Each written extension contained the bold-type words, 'NON-CANCELABLE CONTRACT,' and each written contract contained the bold-type words, 'NON-CANCELABLE NEGOTIABLE CONTRACT.' Some of the agreements also contained the bold-type statement, 'I UNDERSTAND THAT NO REFUNDS WILL BE MADE UNDER THE TERMS OF THIS CONTRACT.'

On September 24, 1961 plaintiff was severely injured in an automobile collision, rendering him incapable of continuing his dancing lessons. At that time he had contracted for a total of 2734 hours of lessons, for which he had paid $24,812.80 [about $176,000 in 2010 dollars]. Despite written demand defendants refused to return any of the money, and this suit in equity ensued. At the close of plaintiff's case the trial judge dismissed the fraud count (Count II), describing the instructors' sales techniques as merely 'a matter of pumping salesmanship.' At the close of all the evidence a decree was entered under Count I in favor of plaintiff for all prepaid sums, plus interest, but minus stipulated sums attributable to completed lessons.

Plaintiff was granted rescission on the ground of impossibility of performance. The applicable legal doctrine is expressed in the Restatement of Contracts, s 459, as follows:

A duty that requires for its performance action that can be rendered only by the promisor or some other particular person is discharged by his death or by such illness as makes the necessary action by him impossible or seriously injurious to his health, unless the contract indicates a contrary intention or there is contributing fault on the part of the person subject to the duty....

Defendants do not deny that the doctrine of impossibility of performance is generally applicable to the case at bar. Rather they assert that certain contract provisions bring this case within the Restatement's limitation that the doctrine is inapplicable if 'the contract indicates a contrary intention.' It is contended that such bold type phrases as 'NON-CANCELABLE CONTRACT,' 'NON-CANCELABLE NEGOTIABLE CONTRACT' and 'I UNDERSTAND THAT NO REFUNDS WILL BE MADE UNDER THE TERMS OF THIS CONTRACT' manifested the parties' mutual intent to waive their respective rights to invoke the doctrine of impossibility. This is a construction which we find unacceptable. Courts engage in the construction and interpretation of contracts with the sole aim of determining the intention of the parties. We need rely on no construction aids to conclude that plaintiff never contemplated that by signing a contract with such terms as 'NON-CANCELABLE' and 'NO REFUNDS' he was waiving a remedy expressly recognized by Illinois courts. Were we also to refer to established tenets of contractual construction, this conclusion would be

equally compelled. An ambiguous contract will be construed most strongly against the party who drafted it. [Citation] Exceptions or reservations in a contract will, in case of doubt or ambiguity, be construed least favorably to the party claiming the benefit of the exceptions or reservations. Although neither party to a contract should be relieved from performance on the ground that good business judgment was lacking, a court will not place upon language a ridiculous construction. We conclude that plaintiff did not waive his right to assert the doctrine of impossibility.

Plaintiff's Count II, which alleged fraud and sought punitive damages, was dismissed by the trial judge at the close of plaintiff's case. It is contended on appeal that representations to plaintiff that he had 'exceptional potential to be a fine and accomplished dancer,' that he had 'exceptional potential' and that he was a 'natural born dancer' and a 'terrific dancer' fraudulently induced plaintiff to enter into the contracts for dance lessons.

Generally, a mere expression of opinion will not support an action for fraud. [Citation] In addition, misrepresentations, in order to constitute actionable fraud, must pertain to present or pre-existing facts, rather than to future or contingent events, expectations or probabilities. [Citation] Whether particular language constitutes speculation, opinion or averment of fact depends upon all the attending facts and circumstances of the case. [Citation] Mindful of these rules, and after carefully considering the representations made to plaintiff, and taking into account the business relationship of the parties as well as the educational background of plaintiff, we conclude that the instructors' representations did not constitute fraud. The trial court correctly dismissed Count II. We affirm.

Affirmed.

CASE QUESTIONS

1. Why is it relevant that the plaintiff was "a bachelor who lived alone in a one-room attic apartment"?
2. The contract here contained a "no cancellation" clause; how did the court construe the contract to allow cancellation?
3. Plaintiff lost on his claim of fraud (unlike Mrs. Vokes in the similar case in Chapter 10 "Real Assent" against another franchisee of Arthur Murray, Inc.). What defense was successful?
4. What is the controlling rule of law here?

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14.3: Summary and Exercises

Summary

The law of contracts has various rules to determine whether obligations have been discharged. Of course, if both parties have fully performed the contract, duties will have terminated. But many duties are subject to conditions, including conditions precedent and subsequent, conditions requiring approval of the promisee or someone else, and clauses that recite time to be of the essence.

A contract obligation may be discharged if the promisor has not received the benefit of the promisee's obligation. In some cases, failure to carry out the duty completely will discharge the corresponding obligation (material breach); in other cases, the substantial performance doctrine will require the other party to act.

A contract may have terminated because one of the parties tells the other in advance that he will not carry out his obligations; this is called anticipatory breach. The right to adequate assurance allows one party to determine whether the contract will be breached by the other party.

There are other events, too, that may excuse performance: impracticability (including the UCC rules governing impracticability in contracts for the sale of goods), death or incapacity of the obligor, destruction of the thing necessary for the performance, government prohibition, frustration of purpose, and power of avoidance.

Finally, note that not all obligations are created by contract, and the law has rules to deal with discharge of duties in general. Thus, in the appropriate cases, the obligee may cancel or surrender a written contract, may enter into an accord, may agree to rescind the agreement, or may release the obligor. Or the obligor may show a material alteration in the contract, may become bankrupt, or may plead the statute of limitations—that is, plead that the obligee waited too long to sue. Or the parties may, by word or deed, mutually abandon the agreement. In all these ways, duties may be discharged.

EXERCISES

1. Theresa hired Contractor to construct a large office building. Theresa's duty to pay Contractor was conditioned on receipt of a statement from her architect that the building complied with the terms of the contract. Contractor completed the building but used the wrong color fixtures in the bathrooms. The architect refused to approve the work, but under state law, Contractor was considered to have substantially performed the contract. Is he entitled to payment, less damages for the improper fixtures? Explain.
2. In early 1987, Larry McLanahan submitted a claim to Farmers Insurance for theft of his 1985 Lamborghini while it was on consignment for sale in the Los Angeles area. The car had sustained extensive damage, which McLanahan had his mechanic document. The insurance policy contained this language: "Allow us to inspect and appraise the damaged vehicle before its repair or disposal." But after considerable delay by Farmers, McLanahan sold the car to a cash buyer without notifying Farmers. He then sued Farmers for its refusal to pay for damages to his car. Upon what legal theory did Farmers get a summary judgment in its favor?
3. Plaintiff sold a tavern to Defendants. Several months later, Defendants began to experience severe problems with the septic tank system. They informed Plaintiff of the problem and demanded the return of their purchase money. Plaintiff refused. Defendants took no formal action against Plaintiff at that time, and they continued to operate the tavern and make their monthly payments under the contract. Some months later, Defendants met with state officials from the Departments of Environmental Quality, Health, and Liquor Control Commission. The officials warned Defendants that because of the health hazards posed by the septic tank problems, Defendants' licenses might not be renewed. As a result, Defendants decided to close the tavern and attempt to reopen when the septic tank was repaired. Defendants advertised a going-out-of-business sale. The purpose of the sale was to deplete the tavern's inventory before closing. Plaintiff learned about the sale and discovered that Defendants had removed certain personal property from the tavern. He sued the Defendants, claiming, among other things, that they had anticipatorily breached their contract with him, though he was receiving payments on time. Did the Defendants' actions amount to an anticipatory breach?*Crum v. Grant*, 692 P.2d 147 (Or. App., 1984).
4. Julius, a manufacturer of neckties, contracted to supply neckties to a wholesaler. When Julius's factory burned, he failed to supply any, and the wholesaler sued. Is Julius excused from performance by impossibility?
5. The Plaintiff (a development corporation) contracted to buy Defendant's property for $1.8 million. A term in the contract read: "The sale...shall be closed at the office of Community Title Company on May 16th at 10:00 am....Time is of the essence in

this contract." Defendant appeared at the office at 10:00 a.m. on the day designated, but the Plaintiff's agent was not there. Defendant waited for twenty minutes, then left. Plaintiff's agent arrived at 10:30 a.m. and announced that he would not have funds for payment until 1:30 p.m., but Defendant refused to return; she had already made other arrangements to finance her purchase of other real estate. Plaintiff sued Defendant for specific performance. Who wins, and why?

6. A contract between the Koles and Parker-Yale provided for completion of the Koles's condominium unit within 180 days. It also authorized the Koles to make written changes in the plans and specifications. Construction was not completed within the 180-day period, and the Koles, prior to completion, sent a letter to Parker-Yale rescinding the contract. Were the Koles within their rights to rescind the contract?
7. Plaintiff contracted to buy Defendant's commercial property for $1,265,000. Under the terms of the agreement, Defendant paid $126,000 as an earnest-money deposit, which would be retained by Plaintiff as liquidated damages if Defendant failed to close by the deadline. Tragically, Defendant's husband died four days before the closing deadline, and she was not able to close by the deadline. She was relying on her husband's business to assist her in obtaining the necessary financing to complete the purchase, and after his death, she was not able to obtain it. Plaintiff sued for the $126,000; Defendant argued that the purpose of the contract was frustrated due to the untimely death of her husband. Is this a good argument?
8. Buyer contracted to buy Seller's house for $290,000; the contract included a representation by Buyer "that he has sufficient cash available to complete this purchase." Buyer was a physician who practiced with his uncle. He had received assurances from his uncle of a loan of $200,000 in order to finance the purchase. Shortly after the contract was executed, the uncle was examined by a cardiologist, who found his coronary arteries to be dangerously clogged. As a result, the uncle immediately had triple bypass surgery. After the operation, he told Buyer that his economic future was now uncertain and that therefore it was impossible for him to finance the house purchase. Meanwhile, Seller, who did not know of Buyer's problem, committed herself to buy a house in another state and accepted employment there as well. Buyer was unable to close; Seller sued. Buyer raised as a defense impossibility or impracticability of performance. Is the defense good?
9. Pursuant to a contract for the repair and renovation of a swimming pool owned by Defendant (City of Fort Lauderdale), Plaintiff commenced the work, which included resurfacing the inside of the pool, and had progressed almost to completion. Overnight, vandals damaged the work Plaintiff had done inside the pool, requiring that part of the work be redone. Plaintiff proceeded to redo the work and billed Defendant, who paid the contract price but refused to pay for the additional work required to repair the damage. Did the damage constitute destruction of subject matter discharging Plaintiff from his obligation to complete the job without getting paid extra?
10. Apache Plaza (the landlord) leased space to Midwest Savings to construct a bank building in Apache's shopping mall, based on a prototype approved by Apache. Midwest constructed the building and used it for twelve years until it was destroyed by a tornado. Midwest submitted plans for a new building to Apache, but Apache rejected the plans because the new building was larger and had less glass than the old building or the prototype. Midwest built it anyway. Its architect claimed that certain changes in the structure of the new building were required by new regulations and building codes, but he admitted that a building of the stipulated size could have been constructed in compliance with the applicable codes. Apache claimed $210,000 in damages over the term of the lease because the new building consumed more square feet of mall space and required more parking. Midwest claimed it had substantially complied with the lease requirements. Is this a good defense?*Apache Plaza, Ltd. v. Midwest Sav. Ass'n*, 456 N.W.2d 729 (Minn. App. 1990).

SELF-TEST QUESTIONS

1. A condition precedent
    1. is a condition that terminates a duty
    2. is always within the control of one of the parties
    3. is an event giving rise to performance
    4. is a condition that follows performance
2. If Al and Betty have an executory contract, and if Betty tells Al that she will not be fulfilling her side of the bargain,
    1. Al must wait until the date of performance to see if Betty in fact performs
    2. Al can sue immediately for full contract damages
    3. Al can never sue because the contract was executory when Betty notified him of nonperformance
    4. none of the above
3. Jack contracts with Anne to drive her to the airport Wednesday afternoon in his specially designed stretch limousine. On Wednesday morning Jack's limousine is hit by a drunken driver, and Jack is unable to drive Anne. This is an example of
    1. impossibility of performance
    2. frustration of purpose
    3. discharge by merger
    4. none of the above
4. Jack is ready and willing to drive Anne to the airport. But Anne's flight is cancelled, and she refuses to pay. This is an example

of
    1. impracticability of performance
    2. frustration of purpose
    3. discharge of merger
    4. none of the above
5. Rescission is
    1. the discharge of one party to a contract through substitution of a third person
    2. an agreement to settle for substitute performance
    3. a mutual agreement between parties to a contract to discharge each other's contractual duties
    4. none of the above

SELF-TEST AnswerS

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

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15: REMEDIES

Learning Objectives

After reading this chapter, you should understand the following:

1. The basic theory of contract remedies, and why courts don't just order the promisor to perform as promised
2. The interests that are protected by contract remedies
3. The types of legal remedies
4. The types of equitable remedies
5. The limitations on remedies

We come at last to the question of remedies. A valid agreement has been made, the promisor's duties have not been discharged; he or she has breached the contract. When one party has failed to perform, what are the rights of the parties? Or when the contract has been avoided because of incapacity or misrepresentation and the like, what are the rights of the parties after disaffirmance? These questions form the focus of this chapter. Remedies for breach of contracts for the sale of goods will be considered separately, in Chapter 18.

15.1: Theory of Contract Remedies

15.2: Promisee's Interests Protected by Contract

15.3: Legal Remedies- Damages (Monetary)

15.4: Equitable Remedies

15.5: Limitations on Contract Remedies

15.6: Cases

15.7: Summary and Exercises

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15.1: Theory of Contract Remedies

LEARNING OBJECTIVES

1. Understand the basic purpose of remedies.
2. Recognize that there are two general categories of remedies: legal and equitable.
3. See that courts do not simply order obligors to keep their promise but instead allow them to breach and the nonbreaching party to have remedies for that breach.

Purpose of Remedies

The fundamental purpose of remedies in noncriminal cases is not to punish the breaching party but—if possible—to put the nonbreaching party in the position he or she would have been in had there been no breach. Or, as is said, the purpose is to make the nonbreaching party whole.

There are two general categories of remedies—legal and equitable. In the category of legal remedies are **damages**. Damages are money paid by one party to another; there are several types of damages. In the category of equitable remedies are these three: **specific performance**, which means a person is ordered to deliver a unique thing (land or a unique personal property, such as a painting or an antique car); **injunction**, a judicial order directing a person to stop doing what he or she should not do (such as competing with a former employer in violation of a noncompete agreement); and **restitution**, which means putting the parties back into the position they were in before the contract was made.

Parties Have the Power—but Not the Right—to Breach

Given the importance that contract law places on the intentions of the parties, it might seem natural to assume that the remedy for every breach would be a court order requiring the obligor to perform exactly as promised. Yet this is not the case. Many duties cannot realistically be performed after a breach—time and circumstances often render performance impractical or worthless. Even when performance remains possible, courts frequently decline to compel it.

As Justice Oliver Wendell Holmes Jr. famously observed in 1897, “the duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it.” Holmes’s statement underscores a central principle: the common law of contracts generally seeks to compensate the injured party for losses rather than force the breaching party to perform. In effect, the promisor retains a choice—either perform as agreed or pay damages. This approach, while sometimes criticized, often makes economic sense and can even create efficient outcomes.

Consider a simple illustration. A computer manufacturer contracts for the delivery of custom circuit boards. Before production begins, the manufacturer discovers that a competitor has developed a superior product that makes the boards useless in the market. To force the manufacturer to take delivery of the boards would be wasteful. Instead, awarding damages to the circuit board maker—such as reimbursement of out-of-pocket costs or lost profits—achieves a fairer, more practical result.

The overarching purpose of contract remedies is to protect the reasonable expectations of the nonbreaching party. Put differently, the law of remedies aims, where possible, to place the injured party in the position they would have occupied had the contract been fully performed.

KEY TAKEAWAY

Remedies are intended to make the nonbreaching party whole. The two categories of remedies for breach of contract are legal and equitable. In the legal category are damages; in the equitable category are specific performance, injunctions, and restitution. The law does not force a party to perform; he or she always has the power (though not the right) to breach, and may do so if it is economically more advantageous to breach and suffer the consequence than to perform. Remedies, though, are not (usually) intended to punish the breaching party.

EXERCISES

1. Remedies are not supposed to punish the breaching party, generally. In what circumstances might punishment be a remedy, and what is that called?
2. What is the difference between legal and equitable remedies?
3. Why shouldn't people be forced to perform as they contracted, instead of giving them the power to breach and then be required to pay damages?

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15.2: Promisee's Interests Protected by Contract

LEARNING OBJECTIVE

1. Understand that the nonbreaching party to a contract has certain expectations that contract remedies seek to fulfill to make the nonbreaching party whole.

Contract remedies serve to protect three different interests: an expectation interest, a reliance interest, and a restitution interest. A promisee will have one of these and may have two or all three.

Contract remedies are designed to protect three distinct interests: the **expectation interest**, the **reliance interest**, and the **restitution interest**. A promisee may have one, two, or even all three, depending on the circumstances of the breach.

Expectation Interest

The expectation interest reflects the benefit of the bargain—the value the promisee would have received had the contract been fully performed. The goal of the remedy is to place the promisee in as good a position as if performance had occurred.

Reliance Interest

The reliance interest focuses on losses suffered because the promisee reasonably relied on the contract. Remedies restore the promisee to the position they occupied before the agreement, by reimbursing expenditures or commitments made in anticipation of performance.

Restitution Interest

The restitution interest prevents unjust enrichment by requiring the promisor to return any benefit received from the promisee. Unlike expectation or reliance, restitution is less concerned with the promisee's loss than with the promisor's gain. Restitution is not inherently an "equitable" interest—it is a substantive right that can be protected through either legal or equitable remedies:

- **At law**, restitution may take the form of damages measured by the value of benefits conferred (for example, *quantum meruit* recovery for the reasonable value of services).
- **In equity**, restitution may be enforced through remedies such as **rescission** (canceling the contract and restoring the parties to their pre-contract positions), **injunctions** (to prevent further unjust enrichment or wrongful retention), or restitutionary orders that compel the return of property or benefits. By contrast, **specific performance**—though an equitable remedy—protects the **expectation interest** by compelling actual performance of the contract.

Illustrations

1. No Work Performed.
Suppose a landowner repudiates an executory contract with a builder to construct a garage for $100,000. The builder expected a $10,000 profit (since the cost of construction would have been $90,000). Because the builder has not yet begun work, he has:

- **No restitution interest** (he has conferred nothing),
- **No reliance interest** (he has incurred no expenses),
- **An expectation interest** of $10,000 (the lost profit).

The likely remedy: damages of $10,000.

2. Partial Performance.
Now imagine the builder has already excavated and poured a foundation at a cost of $15,000. In this case:

- His **expectation interest** is $25,000 (the $100,000 contract price minus the $75,000 remaining cost).

- His **reliance interest** is $15,000 (the money already spent).
- His **restitution interest** could be the market value of the foundation to the landowner—recoverable either through legal damages or, in appropriate circumstances, through equitable relief such as rescission paired with restitution.

Choosing Among Interests

The promisee typically selects which interest to pursue, guided by the facts of the case, the nature of the remedies available, and the amount at stake. Courts, for their part, seek to enforce remedies in a manner that is fair, efficient, and consistent with contract principles.

In practice:

- **Expectation** aims to give the benefit of the bargain.
- **Reliance** aims to undo losses from reasonable reliance.
- **Restitution** aims to prevent unjust enrichment.

The choice among these interests often determines not only the measure of recovery but also whether the remedy will be legal, equitable, or both.

KEY TAKEAWAY

A nonbreaching party might have one or more interests that the law seeks to realize: expectation, reliance, and restitution.

EXERCISES

1. What is the expectation interest? The reliance interest? The restitution interest?
2. How are these concepts useful in understanding contract remedies?

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15.3: Legal Remedies- Damages (Monetary)

LEARNING OBJECTIVES

1. Understand what is meant when it is said that damages are a legal remedy (as opposed to an equitable remedy).
2. Understand the names and purposes of the six types of remedies.
3. Know when liquidated damages will be allowed.
4. Recognize the circumstances that might allow punitive damages.

Overview

The promisee—whom we will hereafter refer to as the **nonbreaching party**—has the right to recover damages, or a money award, whenever the other party breaches the contract, unless the contract itself or other circumstances suspend or discharge that right. **Monetary damages** are sums of money paid by one party to the other and are considered a **legal remedy**.

Historically, this distinction stems from the development of the English legal system. Courts of **law** were originally limited to granting monetary relief. If a petitioner sought something other than money—such as an order compelling performance or undoing a contract—recourse had to be made to a separate system of **equity**. In practice, this meant two different sets of courts, procedures, and remedies.

Although today the institutional separation between law and equity no longer exists, the distinction is still recognized. A judge may be described as “sitting in law” when awarding damages, or “sitting in equity” when granting remedies such as injunctions, rescission, restitution, or specific performance. Many modern cases involve claims for both legal and equitable remedies.

We begin, as the common law did, with the legal remedy of damages.

Types of Damages

There are six different types of damages: compensatory, incidental, consequential, nominal, liquidated, and (sometimes) punitive.

Compensatory Damages

Definition and Purpose.
Compensatory damages are paid to directly compensate the nonbreaching party for the value of what was not done or performed. Their purpose is to place the nonbreaching party in the position they would have occupied had the contract been performed.

Measuring the Loss.
Sometimes calculating compensatory damages is straightforward. For example, if a builder would have earned a $10,000 profit on a $100,000 house, and the owner wrongfully cancels, the builder’s expectation interest is $10,000. In other cases, courts look to the reasonable cost of obtaining a substitute performance. If a service can be replaced, the measure of damages is the cost of hiring someone else to perform.

However, the calculation is often difficult, especially when the service is unique and not easily duplicated. If Rembrandt breached a contract to paint your portrait, the loss cannot be measured simply by asking what Van Gogh would charge. Nevertheless, the proper measure remains whatever net value would ultimately have been conferred on the nonbreaching party. Similarly, an author whose publisher breaches a book contract may recover lost royalties (if ascertainable) and the measurable value of her lost reputation and publicity.

Deductions for Savings and Substitutions.
Because the nonbreaching party is usually discharged from further obligations, a breach often results in cost savings. The nonbreaching party may:

- Avoid expenses they otherwise would have incurred,

- Make substitute arrangements and realize partial profits, or
- Repurpose goods purchased for the breached contract.

These avoided losses must be deducted from the damages calculation. The rule is that the nonbreaching party recovers only **net losses, not more.**

Example: An employer breaches a contract to hire a worker at $35,000 for one year. The employee quickly finds similar work for $30,000. Aside from incidental damages (such as job search costs), compensatory damages are limited to $5,000—the difference between the contract salary and the replacement salary.

The Lost Volume Problem.
A special issue arises when the nonbreaching party is a supplier of goods or services who enters a second contract after the first buyer repudiates. The question is whether the second contract is a substitute performance or an additional one.

Example: An automobile dealer contracts to sell a car. Before delivery, the buyer repudiates. The dealer then sells the same car to another buyer. If the dealer can show that he would have sold a car to the second buyer even if the first buyer had performed, then the second sale is not a substitute—it is additional. In that case, the dealer is entitled to recover the full expectation interest from the first buyer, since the breach deprived him of one sale.

The key inquiry in lost volume cases is whether the nonbreaching party would have made the second sale even if no breach had occurred.

Incidental Damages

In addition to compensatory damages, the nonbreaching party may also recover **incidental damages**. These are the reasonable costs and expenses incurred while attempting to minimize losses caused by the breach. They are tied to the nonbreaching party's duty to mitigate damages.

Common examples include:

- Paying a premium to obtain substitute goods or services quickly,
- Covering brokerage fees or special charges to secure a new supplier,
- Incurring transportation, storage, or inspection costs for substitute goods,
- Spending extra money on advertising or recruiting to replace a lost contract or employee.

Illustration: Suppose a seller fails to deliver goods on time, forcing the buyer to purchase replacements from another source at higher shipping costs. The additional shipping charges are incidental damages. Similarly, if an employer breaches a contract, and the employee must spend money on travel or job-placement services to find a new position, those costs may be recovered as incidental damages.

Consequential Damages

A consequential loss is addressed with consequential damages (sometimes called *special damages*). These are damages that do not flow directly from the breach itself but arise from the particular circumstances of the nonbreaching party. Unlike incidental damages, they occur without any additional action by the nonbreaching party.

Examples include:

- **Property damage:** If Ralph installs plumbing incorrectly and the toilet leaks, damaging the floor, the downstairs ceiling, and the rug, he is liable for those additional losses.
- **Lost profits:** If a repair company fails to fix a manufacturer's machine on time, and the manufacturer loses sales as a result, the repair company may be liable for those lost profits.
- **Personal injury or property damage:** If a seller provides a defective machine that injures the buyer or damages property, the seller may be responsible for those losses as consequential damages.

Foreseeability: *Hadley v. Baxendale*

The leading case on consequential damages is *Hadley v. Baxendale* (1854). In this case, the Hadleys operated a flour mill in England. Their mill's crankshaft broke, and they hired Baxendale, a carrier, to transport the shaft to an engineer for repair. Baxendale negligently delayed delivery, and as a result, the mill was shut down for several days, causing the Hadleys to lose profits.

The Hadleys sued to recover their lost profits as damages. The court, however, limited recovery. It ruled that damages for breach of contract should be those that **(1) arise naturally from the breach** or **(2) may reasonably be supposed to have been in the contemplation of both parties at the time of contracting.** Because Baxendale had not been told that the mill would remain shut down until the shaft was returned, the lost profits were not foreseeable and thus not recoverable.

This case established the modern rule of foreseeability: consequential damages are only recoverable if they were foreseeable at the time the contract was made. If the special circumstances were not communicated, the breaching party cannot be held liable for extraordinary losses.

Modern Example

Imagine a retailer who orders 1,000 custom T-shirts from a manufacturer to resell at a major music festival. The festival is a one-time event, and the retailer clearly informs the manufacturer that timely delivery is essential. If the manufacturer delivers the shirts two weeks late—after the festival is over—the retailer cannot resell them and loses significant profits. Because the manufacturer was aware of the event and its timing, those lost profits are **foreseeable consequential damages** and may be recovered in court.

If, however, the retailer had not told the manufacturer about the festival, the lost profits would likely be considered too remote and unrecoverable—just like in *Hadley v. Baxendale*.

Exclusions

Not all costs associated with a breach are recoverable. A common example is **legal expenses**: the costs of suing to enforce the contract are generally not recoverable as damages unless the contract explicitly provides otherwise. However, when the breach forces the nonbreaching party into litigation with a third party, those legal expenses may be claimed as consequential damages.

Business Application

To protect themselves, businesses should **communicate special circumstances in writing** when entering into a contract. If timely delivery, resale at a specific event, or reliance on performance for downstream obligations is critical, stating this clearly ensures that consequential damages will be considered foreseeable—and therefore recoverable—if a breach occurs.

Nominal Damages

When there has been a breach but the nonbreaching party suffers no actual loss—or cannot prove the amount of the loss—the court may award **nominal damages**. The purpose is symbolic: to affirm that a legal right has been violated, even if no compensable harm occurred.

Example: Ricardo contracts to buy a new car from Dealer A. Dealer A breaches, but Ricardo immediately purchases the same car from Dealer B at the same price. Ricardo has suffered no measurable loss. A court may award him nominal damages of, say, $1 or $5 to recognize the breach.

Liquidated Damages

Because damages are sometimes difficult to calculate, parties may agree in advance on a sum to be paid in the event of a breach. These agreed-upon sums are called **liquidated damages**.

Courts will enforce liquidated damages provisions if two conditions are met:

1. The actual damages are difficult to ascertain at the time of contracting, and
2. The liquidated amount is a reasonable estimate of the expected or actual harm.

If the amount is unreasonably large, the provision is treated as a **penalty** and is unenforceable as against public policy.

Example: A concert promoter contracts with a musician, including a clause that the musician will pay $50,000 if she cancels within two weeks of the show. If the promoter can show that actual losses (lost ticket sales, advertising, staffing costs) are difficult to measure and that $50,000 is a reasonable forecast of likely losses, the clause will be enforced. If the clause demanded $1 million, a court would likely strike it down as a penalty.

Punitive Damages

Punitive damages are awarded not to compensate the injured party but to punish the breaching party for willful, malicious, or fraudulent conduct and to deter others from similar behavior.

Because the central purpose of contract law is **compensation, not punishment**, punitive damages are generally not available for breach of contract. There is one important exception: when the breach also constitutes a tort for which punitive damages are permitted.

Examples:

- A creditor holding collateral sells it to a third party even though the debtor is not in default. This act both breaches the loan contract and constitutes the tort of **conversion**. If the conduct was deliberate, punitive damages may be awarded.
- If a party fraudulently induces another into a contract and then breaches, punitive damages may be available under tort law principles of fraud.

Discretion of the Court. Punitive damages are not fixed by statute. The judge or jury determines an appropriate amount based on the seriousness of the conduct and the goal of deterrence. Because punitive damages are meant to sting, wealthy defendants may face higher awards than poorer ones. However, judges have the power to remit (reduce) punitive awards that are excessive or disproportionate.

KEY TAKEAWAY

As the purpose of contract remedies is, in general, to make the nonbreaching party whole, the law allows several types of damages (money paid) to reflect the losses suffered by the nonbreaching party. Compensatory damages compensate for the special loss suffered; consequential damages compensate for the foreseeable consequences of the breach; incidental damages compensate for the costs of keeping any more damages from occurring; nominal damages are awarded if the actual amount cannot be shown or there are no actual damages; liquidated damages are agreed to in advance where the actual amount is difficult to ascertain, and they are allowed if not a penalty; and punitive damages may sometimes be allowed if the breaching party's behavior is an egregious tort, an outrage.

EXERCISES

1. What is the difference between a legal remedy and an equitable remedy?
2. What types of remedies are there, and what purpose does each serve?
3. What must be shown if liquidated damages are to be allowed?
4. Under what circumstances may punitive damages be allowed?

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15.4: Equitable Remedies

LEARNING OBJECTIVES

1. Know when equitable (as opposed to legal) remedies will be allowed.
2. Understand the different types of equitable remedies: specific performance, injunction, and restitution.

Overview

The real explanation for the differences between law and equity lies in the history and politics of England, beginning in the twelfth century. Over time, the English legal system developed two separate court systems: **courts of law**, which could award only money damages, and **courts of equity**, which could provide other forms of relief when money was inadequate. Though the institutional separation is long gone, the distinction between law and equity remains significant in modern remedies.

Several practical differences stand out:

1. **Use of juries.** Juries are used in legal cases but not in equitable ones.
2. **Role of precedent.** Courts of equity rely less rigidly on precedent and more on principles of fairness and justice.
3. **Nature of relief.** Most importantly, equity provides remedies when money damages are inadequate.

In equity, a judge may:

- Order **specific performance**, compelling the breaching party to deliver unique property or perform a promised act;
- Grant an **injunction**, requiring a party to stop engaging in conduct that violates the agreement; or
- Award **restitution**, returning the parties to their precontract positions by requiring the return of consideration.

In short, legal remedies primarily involve monetary compensation, while equitable remedies step in when justice requires action beyond money.

Types of Remedies in Equity

There are three types of equitable remedies: specific performance, injunction, and restitution.

Specific Performance

Definition.
Specific performance is a judicial order requiring the promisor to carry out the precise performance promised in the contract. It is an alternative to damages and may be issued at the court's discretion when money damages are inadequate to compensate the nonbreaching party.

The Role of Uniqueness.
The most important limitation on specific performance is the requirement of **uniqueness**. Courts grant specific performance only where the subject matter of the contract is so unique that monetary damages cannot provide an adequate substitute. The uniqueness requirement ensures that specific performance is reserved for extraordinary cases, not routine breaches.

- **Real estate.** Every parcel of land is considered legally unique. No two pieces of property have exactly the same location, characteristics, or value to a particular buyer. Therefore, contracts to sell real estate are the classic cases for granting specific performance.
- **One-of-a-kind goods.** Specific performance may also be granted for rare or unique personal property—such as antiques, family heirlooms, artworks, or custom-made items—because a buyer cannot simply go out and purchase an identical substitute.
- **Sentimental or personal value.** Even if an item is not rare in the market, its special significance to the nonbreaching party may justify specific performance. For instance, a gold samovar with unique family history may be irreplaceable to its intended

recipient.
- **Non-unique goods.** If the subject matter of the contract is readily available in the marketplace (e.g., standard consumer goods, fungible commodities like grain or oil), then monetary damages are adequate. Courts will not compel specific performance simply because one party would prefer it.

Limitations.
Specific performance is never available to compel personal services, even if the service is highly skilled or unique. Forcing someone to work against their will would amount to **involuntary servitude**, which is prohibited. However, a court may issue an injunction to prevent a party from breaching a **negative covenant** (for example, working for a competitor in violation of a noncompete clause).

Example.
Emily contracts to sell Charlotte a gold samovar, a Russian antique of great sentimental value because it once belonged to Charlotte's mother. Emily repudiates before delivery. Because the samovar is unique and damages would not adequately compensate Charlotte, a court may order Emily to specifically perform the contract and deliver the samovar.

Injunction

Definition.
An injunction is a court order directing a party either to **stop doing something (prohibitory injunction)** or, more rarely, to **affirmatively do something (mandatory injunction)**. In contract law, injunctions are most often used to prevent a party from breaching a promise not to act in a certain way.

Key Principle.
The purpose of an injunction is not to award money damages but to prevent harm that cannot be adequately remedied through compensation. Injunctions are particularly useful when the contract contains a **negative covenant**—a promise not to do something—that is central to the bargain.

Applications in Contract Law.

- **Noncompete agreements.** If an employee agrees not to work for a competitor after leaving a company, and then takes a competing job, a court may issue an injunction preventing the employee from continuing with the competitor.
- **Exclusive rights.** If a seller grants a buyer a right of first refusal on a parcel of land or a unique work of art but attempts to sell it to a third party, the buyer may seek an injunction to prevent the sale.
- **Confidentiality agreements.** Courts may enjoin a party from disclosing trade secrets or confidential business information in violation of a contract.

Enforcement.
Violating an injunction is a serious matter. A party who disobeys may be held in **contempt of court**, facing fines or even imprisonment. Courts rely on this power to ensure compliance when damages alone would not deter or repair the harm.

Limitations.

- Courts are generally cautious in granting injunctions because they restrict freedom of action.
- The nonbreaching party must demonstrate that damages would be inadequate to make them whole.
- Injunctions will not be issued where they would impose disproportionate hardship on the breaching party compared to the benefit to the nonbreaching party.

Examples.

- An employer secures an injunction preventing a former employee from working for a competitor for six months, enforcing a valid noncompete clause.
- A buyer obtains an injunction stopping a seller from selling a rare painting to another purchaser, honoring the buyer's contractual right of first refusal.
- In *Madison Square Garden v. Carnera Corporation* (Section 16.6.3), the court issued an injunction to prevent a boxer from

breaching a negative covenant by fighting elsewhere in violation of his contract.

Restitution

Definition.
Restitution is an equitable remedy designed to **restore to one party the benefit conferred on the other**, preventing unjust enrichment. Unlike expectation or reliance remedies, restitution is not primarily concerned with the nonbreaching party's loss but with ensuring that the breaching party does not unfairly retain a gain.

Key Principle.
Restitution is rooted in fairness: a party should not be enriched at another's expense when the underlying contract fails or is breached. Recovery is limited to the value of the benefit actually conferred and does not serve as a penalty.

Applications in Contract Law.

1. **Total Nonperformance or Repudiation.**
   When one party completely fails to perform, the other party may recover the value of what was provided.
   - *Example:* Calhoun contracts to build $3,000 worth of fences for Arlene for $2,000. He completes the work, but Arlene refuses to pay. Calhoun may recover the $2,000 contract price. Had Arlene repudiated before completion, Calhoun could recover the market value of his work or the amount by which Arlene's land was enhanced.

2. **Return of Specific Property.**
   Restitution may take the form of specific restitution of property transferred under the contract.
   - *Example:* If Arlene gave Calhoun a Ming vase as consideration for building the fences, and Calhoun breached, Arlene could demand return of the vase.

3. **Measuring Restitution.**
   Courts have discretion in calculating restitution, typically using either:
   - The **market value of services rendered**, or
   - The **value by which the breaching party's property or wealth was enhanced.**
   - *Example:* Calhoun agrees to construct ten fences for $25,000 but only builds three, worth $7,500 on the market. If the fences increase Arlene's property value by $8,000, restitution may be set at either $7,500 or $8,000, depending on fairness. Courts usually adopt the smaller measure to prevent disproportionate awards.

4. **Part Performance and Then Breach.**
   Even a breaching party may sometimes recover in restitution if the benefit conferred exceeds the loss suffered by the nonbreaching party.
   - *Example:* Calhoun pays Arlene $30,000 toward a $120,000 land purchase but repudiates before closing. Arlene resells the property for $110,000, suffering a $10,000 loss. Calhoun may recover $20,000 in restitution ($30,000 paid minus Arlene's $10,000 loss). Otherwise, Arlene would be unjustly enriched by receiving $140,000 for property worth $120,000.

5. **Other Situations.**
   Restitution may be available when a contract is void or voidable due to incapacity, mistake, misrepresentation, duress, or the Statute of Frauds (unless this would frustrate the statute's purpose). It may also be available if duties are discharged due to impossibility, impracticability, frustration of purpose, failure of a condition, or a beneficiary's disclaimer.

Limitations.

- Restitution is not meant to punish the breaching party; recovery is limited to the value conferred.
- Courts avoid awarding excessive amounts, particularly where the benefit conferred cannot be reasonably measured (e.g., lifesaving medical treatment).
- Restitution is unavailable when the only remaining obligation is for payment of a definite sum of money. In that case,

expectation damages suffice.

KEY TAKEAWAY

Equitable remedies for breach of contract are available when legal remedies won't make the nonbreaching party whole. The equitable remedies are specific performance (an order directing a person to deliver to the buyer the unique thing the seller contracted to sell), injunction (an order directing a person to stop doing that which he should not do), and restitution (the return by one party of the benefit conferred on him when the contract is not performed, to the extent necessary to avoid imposing a penalty on the breaching party).

EXERCISES

1. Buyer contracts to buy a 1941 four-door Cadillac convertible from Seller for $75,000. Seller, having found a Third Party who will pay $85,000 for the car, refuses to sell to Buyer. What is Buyer's remedy?
2. Assume Third Party had paid the $85,000 and Seller was ordered to sell to Buyer. What is Third Party's remedy?
3. Professor Smith contracts to teach business law at State University for the academic year. After the first term is over, she quits. Can State University get an order of specific performance or an injunction requiring Professor Smith to return for the second term?
4. Now suppose that the reason Professor Smith quit work at State University is because she got a better job at Central University, fifteen miles away. Can State University get an injunction prohibiting her from teaching at Central University?

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15.5: Limitations on Contract Remedies

LEARNING OBJECTIVES

1. Understand that there are various rules that limit recovery for the nonbreaching party in a contract case.
2. Know how these concepts serve to limit contract remedies: foreseeability, mitigation of damages, certainty of damages, loss of power of avoidance, election of remedies, and agreement of the parties.

Limitations on Remedies

The purpose of contract remedies is to place the nonbreaching party, as nearly as possible, in the position he or she would have occupied had the contract been performed. But remedies are not unlimited. Both legal and equitable remedies are subject to restrictions that ensure fairness, prevent double recovery, and maintain predictability in the law.

The principal limitations are: **foreseeability, mitigation of damages, certainty of damages, loss of the power of avoidance, and election of remedies.**

Foreseeability

Definition and Rule.
The doctrine of foreseeability operates as a **limitation on consequential damages**. Consequential damages—losses that do not flow directly from the breach but arise because of the nonbreaching party's special circumstances—are recoverable only if they were **reasonably foreseeable** to the breaching party at the time of contracting.

This principle comes from the famous English case *Hadley v. Baxendale* (1854), which established that damages must either:

1. Arise naturally from the breach (the kind of loss that ordinarily results from such a breach), or
2. Have been within the contemplation of both parties at the time of contracting (special circumstances communicated to and understood by both).

Losses outside these categories are considered too remote and cannot be recovered.

Purpose of the Rule.
The foreseeability requirement serves to:

- **Protect fairness.** It prevents breaching parties from being blindsided by liability for extraordinary losses they could not have anticipated.
- **Promote efficiency.** It encourages contracting parties to disclose special circumstances so risks can be priced into the bargain or addressed with special terms.

Applications and Examples.

- **General damages (direct).** If a supplier fails to deliver materials on time and the buyer must purchase substitutes at a higher price, the increased cost is a direct and foreseeable loss.
- **Consequential damages (special).** If the supplier's failure causes the buyer's factory to shut down and lose profits, those losses are recoverable only if the supplier knew, at the time of contracting, that timely delivery was critical to production.
- **Case example – *Hadley v. Baxendale*.** The carrier delayed in delivering a broken mill shaft for repair. The mill lost profits while shut down, but the court denied recovery because the carrier had not been told that the mill would remain idle until the shaft was returned.

Modern Applications.
Courts still apply *Hadley*'s rule today, distinguishing between:

- **Direct damages:** Always recoverable if proven (e.g., cost of cover, lost contract price).
- **Consequential damages:** Recoverable only if foreseeable at the time of contracting.

Example: A software vendor breaches a contract to deliver a program on time. The buyer claims lost profits from a missed product launch. Unless the vendor knew about the launch and its importance, those profits are not recoverable as consequential damages.

Limitations.

- Foreseeability is assessed **at the time of contracting**, not at the time of breach.
- The burden of proof is on the nonbreaching party to show that the damages were foreseeable.
- Even foreseeable consequential damages may be denied if they are speculative (tying foreseeability to the certainty doctrine).

Summary.
The doctrine of foreseeability is the central limitation on **consequential damages**. It ensures that recovery is limited to losses the breaching party could reasonably have anticipated, balancing fairness to the breaching party with protection for the injured party's legitimate expectations.

Mitigation of Damages

Definition and Rule.
The doctrine of mitigation requires that the nonbreaching party take **reasonable steps to reduce or avoid further loss** resulting from the breach. The law will not permit damages to accumulate needlessly when the injured party could have reasonably minimized the harm. If the nonbreaching party fails to mitigate, the damages recoverable will be reduced accordingly.

Purpose of the Rule.

- **Fairness.** It prevents the injured party from recovering losses that could have been avoided with reasonable effort.
- **Efficiency.** It encourages both parties to act in a commercially reasonable manner after breach, reducing waste and discouraging strategic behavior.

Applications in Contract Law.

1. **Employment contracts.** If an employee is wrongfully discharged, he must make reasonable efforts to find comparable employment. If he refuses a substantially similar job, the wages he could have earned are deducted from his damages.
2. **Sales of goods.** Under the Uniform Commercial Code, a buyer whose seller fails to deliver goods must attempt to "cover" by purchasing substitute goods at a reasonable price. Similarly, a seller whose buyer repudiates must attempt to resell the goods to another purchaser.
3. **Construction contracts.** If an owner breaches by refusing to allow construction to proceed, the contractor must stop work and avoid unnecessary expenses; continued performance after repudiation cannot be charged to the breaching party.

Examples.

- *Employment:* Alice is wrongfully fired from her $50,000/year job. She quickly finds similar employment at $45,000/year. Her damages are $5,000—the difference between the contracts—rather than the full $50,000.
- *Goods:* A buyer contracts to purchase grain at $2 per bushel. The seller repudiates, and the buyer reasonably covers by purchasing from another supplier at $2.20 per bushel. The buyer can recover the $0.20 difference per bushel as damages. If the buyer made no effort to cover despite available alternatives, damages might be limited.
- *Construction:* A contractor is hired to build a house. Midway through, the owner repudiates. The contractor cannot continue construction and claim the full contract price; instead, he must stop work and seek damages for the work performed and lost profits.

Limitations.

- The nonbreaching party must act **reasonably**, not perfectly. The law does not require extraordinary effort, excessive expense, or undue risk.
- The duty to mitigate does not require the injured party to accept employment or substitute performance that is inferior or substantially different.
- What counts as "reasonable" is judged case by case, in light of industry standards and practical realities.

Connection to Damages.

- **Compensatory damages** are reduced by the amount of loss avoided through reasonable mitigation.
- **Incidental damages** (such as expenses in arranging substitute goods or services) are recoverable precisely because they are part of the mitigation process.

Summary.
The mitigation doctrine limits damages by requiring the nonbreaching party to take reasonable steps to reduce the harm from breach. It balances the right to be compensated with the obligation to avoid unnecessary loss.

Certainty of Damages

Definition and Rule.
Damages for breach of contract must be proven with **reasonable certainty**. Courts will not award damages that are speculative, conjectural, or based on guesswork. The nonbreaching party bears the burden of showing, with reliable evidence, the existence and extent of the loss.

This rule does not require mathematical precision but does require a solid factual basis. If damages cannot be measured with sufficient certainty, the claim will fail.

Purpose of the Rule.

- **Fairness.** Prevents breaching parties from being saddled with excessive or imaginary liability.
- **Predictability.** Ensures that contract damages are grounded in evidence and can be reasonably anticipated.
- **Encouragement of recordkeeping.** Incentivizes parties to document performance, expenses, and profits so that losses can be proven if breach occurs.

Applications in Contract Law.

1. **Lost profits of established businesses.** Courts may award lost profits where the business has a reliable track record and records to prove what profits would have been.
2. **Lost profits of new businesses.** Traditionally, courts refused to award lost profits for new ventures, viewing them as too speculative. Modern courts sometimes allow recovery if the plaintiff can present credible market data, expert testimony, or evidence of comparable businesses.
3. **Service contracts.** Damages for loss of unique services are recoverable if the value of those services can be reasonably measured (e.g., the cost to hire a substitute performer).

Examples.

- *Established business:* A clothing retailer contracts with a supplier for holiday merchandise. The supplier breaches. The retailer can prove, based on past years' records, that holiday sales would have generated $50,000 in profits. Those profits are recoverable as damages.
- *New business:* A startup restaurant sues for lost profits when its supplier fails to deliver equipment on time. Without a sales history, damages may be denied as speculative—unless the owner can present reliable market studies or evidence of comparable restaurants.
- *Speculative claims denied:* A software developer claims $5 million in "brand recognition losses" after a contract breach but

provides no reliable measure of such losses. The claim would be rejected under the certainty doctrine.

Limitations.

- Courts draw a line between **uncertain damages** (where the fact of damage cannot be proven) and **uncertain amounts** (where the fact of damage is clear, but the exact sum is difficult to calculate). Only the former bars recovery.
- Where damages are clearly established but hard to calculate precisely, courts often allow recovery of a **reasonable estimate** based on available evidence.

Loss of Power of Avoidance

Definition and Rule.
The remedy of rescission (or avoidance) allows a party to cancel a contract and be restored to their precontract position. However, the **power to avoid a contract can be lost** if the injured party, after learning of the grounds for avoidance, affirms the contract, delays too long, acts inconsistently with avoidance, or if third-party rights intervene. Once the power of avoidance is lost, the party is limited to other remedies, such as damages.

Purpose of the Rule.

- **Fairness.** Prevents a party from holding the contract in suspense, deciding later whether to affirm or avoid based on changing circumstances.
- **Certainty and stability.** Ensures that contracts are either enforced or set aside in a timely manner, giving both parties clarity about their obligations.
- **Protection against opportunism.** Stops an injured party from reaping benefits under the contract and then later attempting to avoid it when convenient.

Ways the Power of Avoidance May Be Lost.

1. **Affirmation or ratification.** If the injured party continues to perform, accepts benefits, or otherwise indicates intent to abide by the contract after discovering grounds for rescission, the right to avoid is lost.
2. **Unreasonable delay.** A party who waits too long to exercise avoidance may be deemed to have elected to affirm.
3. **Acts inconsistent with avoidance.** Taking actions inconsistent with rescission—such as reselling goods or substantially altering them—can extinguish the power to avoid.
4. **Intervening rights of third parties.** If property passes into the hands of an innocent third party, the right to avoid may be cut off.

Examples.

- *Fraudulent inducement:* A buyer discovers misrepresentation but resells the goods rather than rescinding. By affirming, the buyer loses the right to avoid.
- *Minor's contract:* Michelle, age 17, sells her watch to Betty Buyer. Upon reaching majority, Michelle ordinarily could disaffirm. But if Betty sells the watch to an innocent third party before Michelle disaffirms, Michelle cannot recover it from the third party.
- *Bad check:* Salvador sells his car to Bill Buyer, who pays with a bad check. If the check bounces, Salvador could rescind by returning the check and reclaiming the car. But if Bill sells the car to Pat Purchaser before the check bounces, Salvador cannot reclaim it from Pat, who acquired good title. (Some exceptions apply, but the general rule protects innocent third-party purchasers.)
- *Delay in rescission:* A party induced into a contract by duress waits years before seeking rescission. The delay bars avoidance.

Limitations.

- Courts require rescission to be sought **promptly** once grounds are known.
- Rescission may be denied under the **clean hands** doctrine if the party seeking it has acted inequitably.

- Intervening third-party rights often cut off avoidance, especially where the third party is a **good-faith purchaser for value**.

Election of Remedies

Definition.
The doctrine of election of remedies addresses situations in which the nonbreaching party may appear to have two or more remedies available for the same breach. Where those remedies are mutually exclusive, the law may require the injured party to choose one and forgo the others.

Purpose.
At its core, the doctrine seeks to prevent **double recovery**—that is, compensating the injured party more than once for the same loss.

At Common Law

Traditionally, common law courts applied the doctrine of election of remedies strictly. A defrauded party was required to elect promptly upon discovering the fraud.

- **Rule.** The defrauded party could either:
  1. **Rescind** the contract, returning both parties to their precontract position, **or**
  2. **Affirm** the contract and seek damages for the fraudulent misrepresentation.

But the party could not do both.

- **Example:** Buyer purchases real estate from Seller for $300,000. Seller fraudulently represents that water is available. Buyer spends $60,000 drilling wells before giving up and sues Seller for $360,000 (return of purchase price plus drilling costs). Under the traditional rule, Buyer would not recover the $360,000 because rescission should have been elected upon discovery of fraud. Instead, Buyer could recover only $60,000 in damages (*Merritt v. Craig*, 746 A.2d 923 (Md. 2000)).
- **Criticism.** The doctrine has been widely criticized as overly rigid. Courts and commentators argue that it focuses too much on labels and technicalities, sometimes undercompensating victims while protecting wrongdoers. As one court put it:

> "A host of commentators support elimination of the election of remedies doctrine. A common theme is that the doctrine substitutes labels and formalism for inquiry into whether double recovery results in fact. The rigid doctrine goes to the other extreme, actually resulting in the under compensation of fraud victims and the protection of undeserving wrongdoers."
> — *Head & Seemann, Inc. v. Gregg*, 311 N.W.2d 667 (Wis. App. 1981).

Under the UCC

The **Uniform Commercial Code (UCC)** rejects the strict election of remedies doctrine. Instead, remedies are **cumulative**, meaning that a nonbreaching party may pursue multiple remedies so long as they do not result in double recovery.

- **Section 2-703(1):** "Whether the pursuit of one remedy bars another depends entirely on the facts of the individual case."
- **Section 2-721:** Specifically provides that in cases of fraud, neither rescission of the contract, nor return or rejection of goods, bars a claim for damages or other remedies permitted under the UCC.

Application: A buyer may rescind a fraudulent sales contract, return the goods, and still pursue damages for losses caused by the fraud. The flexibility of the UCC reflects a modern approach that prioritizes fairness over formalism.

Tort versus Contract

Sometimes the same conduct gives rise to both a breach of contract claim and a tort claim. In these cases, the injured party may face a practical choice between suing in tort or contract.

Considerations include:

1. **Statute of limitations.** Contract actions often have longer limitation periods than tort actions.
2. **Allowable damages.** Tort claims may permit punitive damages or compensation for pain and suffering, which are generally unavailable in contract.
3. **Expert testimony.** In some contract cases, expert testimony may be unnecessary, while it would be required in a tort action.
4. **Insurance coverage.** Insurance policies typically exclude intentional torts. Framing a claim in contract may increase the likelihood of recovery under the breaching party's insurance.

Example: A physician promises that surgery will be risk-free but performs negligently, scarring the patient. The patient could sue in tort (medical malpractice) or in contract (breach of warranty). The choice may depend on the kinds of damages sought, the statute of limitations, and insurance coverage.

Legal versus Extralegal Remedies

Finally, even where legal remedies are available, parties may elect not to pursue them in court. Litigation can be disruptive, expensive, and damaging to ongoing relationships, especially in commercial contexts. Businesspeople often prefer to settle disputes privately, renegotiate contracts, or even overlook smaller breaches rather than bring suit.

The decision whether to sue is ultimately strategic and personal, balancing legal rights with practical, financial, and relational considerations. Lawyers may advise, but clients decide.

KEY TAKEAWAY

There are several limitations on the right of an aggrieved party to get contract remedies for a breach besides any limitations fairly agreed to by the parties. The damages suffered by the nonbreaching party must be reasonably foreseeable. The nonbreaching party must make a reasonable effort to mitigate damages, or the amount awarded will be reduced by the damages that could have been avoided. The party seeking damages must be able to explain within reason how much loss he has suffered as a result of the breach. If he cannot articulate with any degree of certainty—if the damages are really speculative—he will be entitled to nominal damages and that's all. There are circumstances in which a party who could have got out of a contractual obligation—avoided it—loses the power to do so, and her remedy of avoidance is lost. Not infrequently, a person will enter into a contract for services or goods that contains a limitation on her right to damages in case the other side breaches. That's all right unless the limitation is unconscionable. Sometimes parties are required to make an election of remedies: to choose among two or more possible bases of recovery. If the remedies are really mutually exclusive and one is chosen, the aggrieved party loses the right to pursue the others. And of course a person is always free not to pursue any remedy at all for breach of contract; that may be strategically or economically smart in some circumstances.

EXERCISES

1. When one party to a contract breaches, what duty, if any, is then imposed on the other party?
2. A chef who has never owned her own restaurant sues a contractor who failed to finish building the chef's first restaurant on time. She presents evidence of the profits made by similar restaurants that have been in business for some time. Is this good evidence of the damages she has suffered by the delay? To what damages is she entitled?
3. Rebecca, seventeen years and ten months old, buys a party dress for $300. She wears it to the junior prom but determines it doesn't look good on her. She puts it in her closet and forgets about it until six months later, when she decides to return it to the store. Is she now entitled to the remedy of rescission?
4. What is the difference between *rescission* and *restitution*?
5. Why are parties sometimes required to make an election of remedies?

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15.6: Cases

Consequential Damages

EBWS, LLC v. Britly Corp.

928 A.2d 497 (Vt. 2007)

Reiber, C.J.

The Ransom family owns Rock Bottom Farm in Strafford, Vermont, where Earl Ransom owns a dairy herd and operates an organic dairy farm. In 2000, the Ransoms decided to build a creamery on-site to process their milk and formed EBWS, LLC to operate the dairy-processing plant and to market the plant's products. In July 2000, Earl Ransom, on behalf of EBWS, met with Britly's president to discuss building the creamery....In January 2001, EBWS and Britly entered into a contract requiring Britly to construct a creamery building for EBWS in exchange for $160,318....The creamery was substantially completed by April 15, 2001, and EBWS moved in soon afterward. On June 5, 2001, EBWS notified Britly of alleged defects in construction. [EBWS continued to use the creamery pending the necessity to vacate it for three weeks when repairs were commenced].

On September 12, 2001, EBWS filed suit against Britly for damages resulting from defective design and construction....

Following a three-day trial, the jury found Britly had breached the contract and its express warranty, and awarded EBWS: (1) $38,020 in direct damages, and (2) $35,711 in consequential damages....

...The jury's award to EBWS included compensation for both direct and consequential damages that EBWS claimed it would incur while the facility closed for repairs. Direct damages [i.e., compensatory damages] are for "losses that naturally and usually flow from the breach itself," and it is not necessary that the parties actually considered these damages. [Citation]. In comparison, special or consequential damages "must pass the tests of causation, certainty and foreseeability, and, in addition, be reasonably supposed to have been in the contemplation of both parties at the time they made the contract."

...The court ruled that EBWS could not recover for lost profits because it was not a going concern at the time the contract was entered into, and profits were too speculative. The court concluded, however, that EBWS could submit evidence of other business losses, including future payment for unused milk and staff wages....

At trial, Huyffer, the CEO of EBWS, testified that during a repairs closure the creamery would be required to purchase milk from adjacent Rock Bottom Farm, even though it could not process this milk. She admitted that such a requirement was self-imposed as there was no written output contract between EBWS and the farm to buy milk. In addition, Huyffer testified that EBWS would pay its employees during the closure even though EBWS has no written contract to pay its employees when they are not working. The trial court allowed these elements of damages to be submitted to the jury, and the jury awarded EBWS consequential damages for unused milk and staff wages.

On appeal, Britly contends that because there is no contractual or legal obligation for EBWS to purchase milk or pay its employees, these are not foreseeable damages. EBWS counters that it is common knowledge that cows continue to produce milk, even if the processing plant is not working, and thus it is foreseeable that this loss would occur. We conclude that these damages are not the foreseeable result of Britly's breach of the construction contract and reverse the award....

[W]e conclude that...it is not reasonable to expect Britly to foresee that its failure to perform under the contract would result in this type of damages. While we are sympathetic to EBWS's contention that the cows continue to produce milk, even when the plant is closed down, this fact alone is not enough to demonstrate that buying and dumping milk is a foreseeable result of Britly's breach of the construction contract. Here, the milk was produced by a separate and distinct entity, Rock Bottom Farm, which sold the milk to EBWS....

Similarly, EBWS maintained no employment agreements with its employees obligating it to pay wages during periods of closure for repairs, dips in market demand, or for any other reason. Any losses EBWS might suffer in the future because it chooses to pay its employees during a plant closure for repairs would be a voluntary expense and not in Britly's contemplation at the time it entered the construction contract. It is not reasonable to expect Britly to foresee losses incurred as a result of agreements that are informal in nature and carry no legal obligation on EBWS to perform. "[P]arties are not presumed to know the condition of each

other's affairs nor to take into account contracts with a third party that is not communicated." [Citation] While it is true that EBWS may have business reasons to pay its employees even without a contractual obligation, for example, to ensure employee loyalty, no evidence was introduced at trial by EBWS to support a sound rationale for such considerations. Under these circumstances, this business decision is beyond the scope of what Britly could have reasonably foreseen as damages for its breach of contract....

In addition, the actual costs of the wages and milk are uncertain....[T]he the milk and wages here are future expenses, for which no legal obligation was assumed by EBWS, and which are separate from the terms of the parties' contract. We note that at the time of the construction contract EBWS had not yet begun to operate as a creamery and had no history of buying milk or paying employees. See [Citation] (explaining that profits for a new business are uncertain and speculative and not recoverable). Thus, both the cost of the milk and the number and amount of wages of future employees that EBWS might pay in the event of a plant closure for repairs are uncertain.

Award for consequential damages is reversed....

CASE QUESTIONS

1. Why, according to EBWS's CEO, would EBWS be required to purchase milk from adjacent Rock Bottom Farm, even though it could not process this milk?
2. Surely it is well known in Vermont dairy country that dairy farmers can't simply stop milking cows when no processing plant is available to take the milk—the cows will soon stop producing. Why was EBWS then not entitled to those damages which it will certainly suffer when the creamery is down for repairs?
3. Britly (the contractor) must have known EBWS had employees that would be idled when the creamery shut down for repairs. Why was it not liable for their lost wages?
4. What could EBWS have done at the time of contracting to protect itself against the damages it would incur in the event the creamery suffered downtime due to faulty construction?

Liquidated Damages

Watson v. Ingram

881 P.2d 247 (Wash. 1994)

Johnson, J.

...In the summer of 1990, Wayne Watson offered to buy James Ingram's Bellingham home for $355,000, with a $15,000 [about $24,000 in 2010 dollars] earnest money deposit....

Under the agreement, the entire amount of the purchase price was due in cash on or before December 3, 1990....The agreement required Watson to pay a $15,000 earnest money deposit into escrow at Kelstrup Realty, and provided that "[i]n the event of default by Buyer, earnest money shall be forfeited to Seller as liquidated damages, unless Seller elects to seek actual damages or specific performance. Lastly, the agreement contained a provision entitled "BUYER'S REPRESENTATIONS," which stated, "Buyer represents that buyer has sufficient funds available to close this sale in accordance with this agreement, and is not relying on any contingent source of funds unless otherwise set forth in this agreement"....

On November 10, 1990, Watson sent a written proposal to Ingram seeking to modify the original agreement. The proposed modification would have allowed Watson to defer paying $54,000 of the $355,000 sale price for between 6 and 12 months after the scheduled December closing date. In exchange, Ingram would receive a second lien position on certain real estate Watson owned.

According to Ingram, the November 10 proposal was the first time he realized Watson did not have financing readily available for the purchase of the house. Ingram notified Watson on November 12, 1990, that he would not agree to modify the original agreement and intended to strictly enforce its terms. Ingram was involved in a child custody suit in California and wanted to move to that state as soon as possible....[Further efforts by Ingram to sell to third parties and by Watson to get an extension from Ingram failed.]

In September 1991, Ingram finally sold the house to a third party for $355,000, the same price that Watson had agreed to pay in December 1990.

Ingram and Watson each sought to recover Watson's $15,000 earnest money held in escrow. On December 4, 1990, Ingram wrote to Kelstrup Realty, indicating he was entitled to the $15,000 earnest money in escrow because Watson had defaulted. In January 1991, Watson filed this action to recover the earnest money, alleging it amounted to a penalty and Ingram had suffered no actual damages....

The trial court found the earnest money "was clearly intended by both parties to be non-refundable" if Watson defaulted and determined $15,000 was "a reasonable forecast by [Ingram and Watson] of damages that would be incurred by [Ingram] if [Watson] failed to complete the purchase". The court entered judgment in favor of Ingram for the amount of the earnest money plus interest. The court also awarded Ingram his attorney fees pursuant to the parties' agreement. The Court of Appeals, Division One, affirmed. Watson now appeals to this court.

This case presents a single issue for review: whether the parties' contract provision requiring Watson to forfeit a $15,000 nonrefundable earnest money deposit is enforceable as liquidated damages. Liquidated damages clauses are favored in Washington, and courts will uphold them if the sums involved do not amount to a penalty or are otherwise unlawful. [Citation] To determine whether liquidated damages clauses are enforceable, Washington courts have applied a 2-part test from the Restatement of Contracts....Liquidated damages clauses are upheld if the following two factors are satisfied:

First, the amount fixed must be a reasonable forecast of just compensation for the harm that is caused by the breach. Second, the harm must be such that it is incapable or very difficult of ascertainment.

The question before this court is whether this test is to be applied as of the time of contract formation (prospectively) or as of the time of trial (retrospectively). We have previously held, the "[r]easonableness of the forecast will be judged as of the time the contract was entered". [Citations]

In contrast, a prior Division One opinion relied upon by Petitioner held the reasonableness of the estimate of damages and the difficulty of ascertainment of harm should be measured as of the time of trial, and earnest money agreements should not be enforceable as liquidated damages if the nonbreaching party does not suffer actual damage. [Citations]

We...adopt the date of contract formation as the proper timeframe for evaluating the Restatement test. The prospective approach concentrates on whether the liquidated sum represents a reasonable prediction of the harm to the seller if the buyer breaches the agreement, and ignores actual damages except as evidence of the reasonableness of the estimate of potential damage.

We believe this approach better fulfills the underlying purposes of liquidated damages clauses and gives greater weight to the parties' expectations. Liquidated damages permit parties to allocate business and litigation risks. Even if the estimates of damages are not exact, parties can allocate and quantify those risks and can negotiate adjustments to the contract price in light of the allocated risks. Under the prospective approach, courts will enforce the parties' allocation of risk so long as the forecasts appear reasonable when made. [Citations]

In addition to permitting parties to allocate risks, liquidated damages provisions lend certainty to the parties' agreements and permit parties to resolve disputes efficiently in the event of a breach. Rather than litigating the amount of actual damages, the nonbreaching party must only establish the reasonableness of the agreement. The prospective approach permits parties to rely on their stipulated amounts without having to precisely establish damages at trial. In contrast, if the reasonableness of the amount is judged retrospectively, against the damage actually suffered, the "parties must fully litigate (at great expense and delay) that which they sought not to litigate." [Citation].

Petitioner argues the prospective approach treats buyers unfairly because it permits sellers to retain earnest money deposits even when the seller suffers no actual damage, and this violates the principle that contract damages should be compensatory only. He further contends that by evaluating parties' liquidated damages agreements against actual damages established at trial, courts can most effectively determine whether such agreements were reasonable and fair.

We disagree. As this court has previously explained, "[w]e are loath to interfere with the rights of parties to contract as they please between themselves [Citations] It is not the role of the court to enforce contracts so as to produce the most equitable result. The parties themselves know best what motivations and considerations influenced their bargaining, and, while, "[t]he bargain may be an unfortunate one for the delinquent party,...it is not the duty of courts of common law to relieve parties from the consequences of their own improvidence..." [Citations]

The retrospective approach fails to give proper weight to the parties' negotiations. At the time of contract formation, unpredictable market fluctuations and variations in possible breaches make it nearly impossible for contracting parties to predict "precisely or within a narrow range the amount of damages that would flow from breach." [Citations]. However, against this

backdrop of uncertainty, the negotiated liquidated damages sum represents the parties' best estimate of the value of the breach and permits the parties to allocate and incorporate these risks in their negotiations. Under the prospective approach, a court will uphold the parties' agreed upon liquidated sum so long as the amount represents a reasonable attempt to compensate the nonbreaching party. On the other hand, if the reasonableness of a liquidated damages provision is evaluated under a retrospective approach, the parties cannot confidently rely on their agreement because the liquidated sum will not be enforced if, at trial, it is not a close approximation of the damage suffered or if no actual damages are proved....

Having adopted the date of contract formation as the proper timeframe for evaluating the Restatement test, the Restatement's second requirement loses independent significance. The central inquiry is whether the specified liquidated damages were reasonable at the time of contract formation....

We also agree with the Court of Appeals that in the context of real estate agreements, a requirement that damages be difficult to prove at trial would undermine the very purposes of the liquidated damage provision: "certainty, assurance that the contract will be performed, and avoidance of litigation". [Citation] It would "encourage litigation in virtually every case in which the sale did not close, regardless of whether the earnest money deposit was a reasonable estimate of the seller's damages." [Citation]

In sum, so long as the agreed upon earnest money agreement, viewed prospectively, is a reasonable prediction of potential damage suffered by the seller, the agreement should be enforced "without regard to the retrospective calculation of actual damages or the ease with which they may be proved". The prospective difficulty of estimating potential damage is a factor to be used in assessing the reasonableness of the earnest money agreement...

The decision of the Court of Appeals is affirmed.

CASE QUESTIONS

1. What does the court here mean when it says that liquidated damages clauses allow the parties to "allocate and incorporate the risks [of the transaction] in their negotiations"?
2. Why is it relevant that the plaintiff Ingram was engaged in a child-custody dispute and wanted to move to California as soon as possible?
3. What, in plain language, is the issue here?
4. How does the court's resolution of the issue seem to the court the better analysis?
5. Why did the plaintiff get to keep the $15,000 when he really suffered no damages?
6. Express the controlling rule of law out of this case.

Injunctions and Negative Covenants

Madison Square Garden Corporation v. Carnera

52 F.2d 47 (2d Cir. Ct. App. 1931)

Chase, J.

On January 13, 1931, the plaintiff and defendant by their duly authorized agents entered into the following agreement in writing:

1. Carnera agrees that he will render services as a boxer in his next contest (which contest, hereinafter called the 'First Contest.'...

9. Carnera shall not, pending the holding of the First Contest, render services as a boxer in any major boxing contest, without the written permission of the Garden in each case had and obtained. A major contest is understood to be one with Sharkey, Baer, Campolo, Godfrey, or like grade heavyweights, or heavyweights who shall have beaten any of the above subsequent to the date hereof. If in any boxing contest engaged in by Carnera prior to the holding of the First Contest, he shall lose the same, the Garden shall at its option, to be exercised by a two weeks' notice to Carnera in writing, be without further liability under the terms of this agreement to Carnera. Carnera shall not render services during the continuance of the option referred to in paragraph 8 hereof for any person, firm or corporation other than the Garden. Carnera shall, however, at all times be permitted to engage in sparring exhibitions in which no decision is rendered and in which the heavy weight championship title is not at stake, and in which Carnera boxes not more than four rounds with any one opponent.'...

Thereafter the defendant, without the permission of the plaintiff, written or otherwise, made a contract to engage in a boxing contest with the Sharkey mentioned in paragraph 9 of the agreement above quoted, and by the terms thereof the contest was to

take place before the first contest mentioned in the defendant's contract with the plaintiff was to be held.

The plaintiff then brought this suit to restrain the defendant from carrying out his contract to box Sharkey, and obtained the preliminary injunction order, from which this appeal was taken. Jurisdiction is based on diversity of citizenship and the required amount is involved.

The District Court has found on affidavits which adequately show it that the defendant's services are unique and extraordinary. A negative covenant in a contract for such personal services is enforceable by injunction where the damages for a breach are incapable of ascertainment. [Citations]

The defendant points to what is claimed to be lack of consideration for his negative promise, in that the contract is inequitable and contains no agreement to employ him. It is true that there is no promise in so many words to employ the defendant to box in a contest with Stribling or Schmeling, but the agreement read as a whole binds the plaintiff to do just that, provided either Stribling or Schmeling becomes the contestant as the result of the match between them and can be induced to box the defendant. The defendant has agreed to 'render services as a boxer' for the plaintiff exclusively, and the plaintiff has agreed to pay him a definite percentage of the gate receipts as his compensation for so doing. The promise to employ the defendant to enable him to earn the compensation agreed upon is implied to the same force and effect as though expressly stated. [Citations] The fact that the plaintiff's implied promise is conditioned, with respect to the contest with the winner of the Stribling-Schmeling match, upon the consent of that performer, does not show any failure of consideration for the defendant's promise, [Citation].

As we have seen, the contract is valid and enforceable. It contains a restrictive covenant which may be given effect. Whether a preliminary injunction shall be issued under such circumstances rests in the sound discretion of the court. [Citation] The District Court, in its discretion, did issue the preliminary injunction....

Order affirmed.

CASE QUESTIONS

1. Why did the plaintiff not want the defendant to engage in any boxing matches until and except the ones arranged by the plaintiff?
2. What assertion did the defendant make as to why his promise was not enforceable? Why wasn't that argument accepted by the court?
3. If the defendant had refused to engage in a boxing match arranged by the plaintiff, would a court force him to do what he had promised?

Limitation on Damages: Mitigation of Damages

Shirley MacLaine Parker v. Twentieth Century-Fox Film Corporation

474 P.2d 689 (Cal. 1970)

Burke, Justice.

Defendant Twentieth Century-Fox Film Corporation appeals from a summary judgment granting to plaintiff the recovery of agreed compensation under a written contract for her services as an actress in a motion picture. As will appear, we have concluded that the trial court correctly ruled in plaintiff's favor and that the judgment should be affirmed.

Plaintiff is well known as an actress....Under the contract, dated August 6, 1965, plaintiff was to play the female lead in defendant's contemplated production of a motion picture entitled "Bloomer Girl." The contract provided that defendant would pay plaintiff a minimum "guaranteed compensation" of $53,571.42 per week for 14 weeks commencing May 23, 1966, for a total of $750,000 [about $5,048,000 in 2010 dollars]. Prior to May 1966 defendant decided not to produce the picture and by a letter dated April 4, 1966, it notified plaintiff of that decision and that it would not "comply with our obligations to you under" the written contract.

By the same letter and with the professed purpose "to avoid any damage to you," defendant instead offered to employ plaintiff as the leading actress in another film tentatively entitled "Big Country, Big Man" (hereinafter, "Big Country"). The compensation offered was identical, as were 31 of the 34 numbered provisions or articles of the original contract. Unlike "Bloomer Girl," however, which was to have been a musical production, "Big Country" was a dramatic "western type" movie. "Bloomer Girl" was to have been filmed in California; "Big Country" was to be produced in Australia. Also, certain terms in the proffered contract varied

from those of the original. Plaintiff was given one week within which to accept; she did not and the offer lapsed. Plaintiff then commenced this action seeking recovery of the agreed guaranteed compensation.

The complaint sets forth two causes of action. The first is for money due under the contract; the second, based upon the same allegations as the first, is for damages resulting from defendant's breach of contract. Defendant in its answer admits the existence and validity of the contract, that plaintiff complied with all the conditions, covenants and promises and stood ready to complete the performance, and that defendant breached and "anticipatorily repudiated" the contract. It denies, however, that any money is due to plaintiff either under the contract or as a result of its breach, and pleads as an affirmative defense to both causes of action plaintiff's allegedly deliberate failure to mitigate damages, asserting that she unreasonably refused to accept its offer of the leading role in "Big Country."

Plaintiff moved for summary judgment...[T]he motion was granted...for $750,000 plus interest...in plaintiff's favor. This appeal by defendant followed....

The general rule is that the measure of recovery by a wrongfully discharged employee is the amount of salary agreed upon for the period of service, less the amount which the employer affirmatively proves the employee has earned or with reasonable effort might have earned from other employment. [Citation] However, before projected earnings from other employment opportunities not sought or accepted by the discharged employee can be applied in mitigation, the employer must show that the other employment was comparable, or substantially similar, to that of which the employee has been deprived; the employee's rejection of or failure to seek other available employment of a different or inferior kind may not be resorted to in order to mitigate damages. [Citations]

In the present case defendant has raised no issue of reasonableness of efforts by plaintiff to obtain other employment; the sole issue is whether plaintiff's refusal of defendant's substitute offer of "Big Country" may be used in mitigation. Nor, if the "Big Country" offer was of employment different or inferior when compared with the original "Bloomer Girl" employment, is there an issue as to whether or not plaintiff acted reasonably in refusing the substitute offer. Despite defendant's arguments to the contrary, no case cited or which our research has discovered holds or suggests that reasonableness is an element of a wrongfully discharged employee's option to reject, or fail to seek, different or inferior employment lest the possible earnings therefrom be charged against him in mitigation of damages.

Applying the foregoing rules to the record in the present case, with all intendments in favor of the party opposing the summary judgment motion—here, defendant—it is clear that the trial court correctly ruled that plaintiff's failure to accept defendant's tendered substitute employment could not be applied in mitigation of damages because the offer of the "Big Country" lead was of employment both different and inferior, and that no factual dispute was presented on that issue. The mere circumstance that "Bloomer Girl" was to be a musical review calling upon plaintiff's talents as a dancer as well as an actress, and was to be produced in the City of Los Angeles, whereas "Big Country" was a straight dramatic role in a "Western Type" story taking place in an opal mine in Australia, demonstrates the difference in kind between the two employments; the female lead as a dramatic actress in a western style motion picture can by no stretch of imagination be considered the equivalent of or substantially similar to the lead in a song-and-dance production.

Additionally, the substitute "Big Country" offer proposed to eliminate or impair the director and screenplay approvals accorded to plaintiff under the original "Bloomer Girl" contract, and thus constituted an offer of inferior employment. No expertise or judicial notice is required in order to hold that the deprivation or infringement of an employee's rights held under an original employment contract converts the available "other employment" relied upon by the employer to mitigate damages, into inferior employment which the employee need not seek or accept. [Citation]

In view of the determination that defendant failed to present any facts showing the existence of a factual issue with respect to its sole defense—plaintiff's rejection of its substitute employment offer in mitigation of damages—we need not consider plaintiff's further contention that for various reasons, including the provisions of the original contract set forth in footnote 1, Ante, plaintiff was excused from attempting to mitigate damages.

The judgment is affirmed.

CASE QUESTIONS

1. Why did Ms. MacLaine refuse to accept the employment opportunity offered by the defendant?
2. Why did the defendant think it should not be liable for any damages as a result of its admitted breach of the original contract?
3. Who has the burden of proof on mitigation issues—who has to show that no mitigation occurred?

4. Express the controlling rule of law out of this case.

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15.7: Summary and Exercises

Summary

Contract remedies serve to protect three different interests: an expectation interest (the benefit bargained for), a reliance interest (loss suffered by relying on the contract), and a restitution interest (benefit conferred on the promisor). In broad terms, specific performance addresses the expectation interest, monetary damages address all three, and restitution addresses the restitution interest.

The two general categories of remedies are legal and equitable. In the former category are compensatory, consequential, incidental, nominal, liquated, and (rarely) punitive damages. In the latter category—if legal remedies are inadequate—are specific performance, injunction, and restitution.

There are some limitations or restrictions on the availability of damages: they must pass the tests of foreseeability and certainty. They must be reasonably mitigated, if possible. And liquidated damages must be reasonable—not a penalty. In some situations, a person can lose the remedy of rescission—the power to avoid a contract—when the rights of third parties intervene. In some cases a person is required to make an election of remedies: to choose one remedy among several, and when the one is chosen, the others are not available any more.

EXERCISES

1. Owner of an auto repair shop hires Contractor to remodel his shop but does not mention that two days after the scheduled completion date, Owner is to receive five small US Army personnel carrier trucks for service, with a three-week deadline to finish the job and turn the trucks over to the army. The contract between Owner and the army has a liquidated damages clause calling for $300 a day for every day trucks are not operable after the deadline. Contractor is five days late in finishing the remodel. Can Owner claim the $1,500 as damages against Contractor as a consequence of the latter's tardy completion of the contract? Explain.
2. Inventor devised an electronic billiard table that looked like a regular billiard table, but when balls dropped into the pocket, various electronic lights and scorekeeping devices activated. Inventor contracted with Contractor to manufacture ten prototypes and paid him $50,000 in advance, on a total owing of $100,000 ($10,000 for each completed table). After the tables were built to accommodate electronic fittings, Inventor repudiated the contract. Contractor broke the ten tables up, salvaged $1,000 of wood for other billiard tables, and used the rest for firewood. The ten intact tables, without electronics, could have been sold for $500 each ($5,000 total). Contractor then sued Inventor for the profit Contractor would have made had Inventor not breached. To what, if anything, is Contractor entitled by way of damages and why?
3. Calvin, a promising young basketball and baseball player, signed a multiyear contract with a professional basketball team after graduating from college. After playing basketball for one year, he decided he would rather play baseball and breached his contract with the basketball team. What remedy could the team seek?
4. Theresa leased a one-bedroom apartment from Landlady for one year at $500 per month. After three months, she vacated the apartment. A family of five wanted to rent the apartment, but Landlady refused. Three months later—six months into what would have been Theresa's term—Landlady managed to rent the apartment to Tenant for $400 per month. How much does Theresa owe, and why?
5. Plaintiff, a grocery store, contracted with Defendant, a burglar alarm company, for Defendant to send guards to Plaintiff's premises and to notify the local police if the alarm was activated. The contract had this language: "It is agreed that the Contractor is not an insurer, that the payments here are based solely on the value of the service in the maintenance of the system described, that it is impracticable and extremely difficult to fix the actual damages, if any, which may proximately result from a failure to perform its services, and in case of failure to perform such services and a resulting loss, its liability shall be limited to $500 as liquidated damages, and not as a penalty, and this liability shall be exclusive."

   A burglary took place and the alarm was activated, but Defendant failed to respond promptly. The burglars left with $330,000. Is the liquidated damages clause—the limitation on Plaintiff's right to recover—valid?

6. The decedent, father of the infant Plaintiff, was killed in a train accident. Testimony showed he was a good and reliable man. Through a representative, the decedent's surviving child, age five, recovered judgment against the railroad (Defendant). Defendant objected to expert testimony that inflation would probably continue at a minimum annual rate of 5 percent for the

next thirteen years (until the boy attained his majority), which was used to calculate the loss in support money caused by the father's death. The calculations, Defendant said, were unreasonably speculative and uncertain, and damages must be proven with reasonable certainty. Is the testimony valid?

7. Plaintiff produced and directed a movie for Defendant, but contrary to their agreement, Plaintiff was not given screen credit in the edited film (his name was not shown). The film was screened successfully for nearly four years. Plaintiff then sued (1) for damages for loss of valuable publicity or advertising because his screen credits were omitted for the years and (2) for an injunction against future injuries. The jury awarded Plaintiff $25,000 on the first count. On the second count, the court held Plaintiff should be able to "modify the prints in his personal possession to include his credits." But Plaintiff appealed, claiming that Defendant still had many unmodified prints in its possession and that showing those films would cause future damages. What remedy is available to Plaintiff?*Tamarind Lithography Workshop v. Sanders*, 193 Cal. Rptr. 409 (Calif. Ct. App., 1983).
8. In 1929 Kerr Steamship Company, Inc. (Plaintiff), delivered to Defendant, the Radio Corporation of America (RCA), a fairly long telegram—in code—to be transmitted to Manila, Philippine Islands, with instructions about loading one of Kerr's ships. By mistake, the telegraph was mislaid and not delivered. As a result of the failure to transmit it, the cargo was not loaded and the freight was lost in an amount of $6,675.29 [about $84,000 in 2010 dollars], profit that would have been earned if the message had been carried. Plaintiff said that because the telegram was long and because the sender was a ship company, RCA personnel should have known it was important information dealing with shipping and therefore RCA should be liable for the consequential damages flowing from the failure to send it. Is RCA liable?
9. Defendant offered to buy a house from Plaintiff. She represented, verbally and in writing, that she had $15,000 to $20,000 of equity in another house and would pay this amount to Plaintiff after selling it. She knew, however, that she had no such equity. Relying on these intentionally fraudulent representations, Plaintiff accepted Defendant's offer to buy, and the parties entered into a land contract. After taking occupancy, Defendant failed to make any of the contract payments. Plaintiff's investigation then revealed the fraud. Based on the fraud, Plaintiff sought rescission, ejectment, and recovery for five months of lost use of the property and out-of-pocket expenses. Defendant claimed that under the election of remedies doctrine, Plaintiff seller could not both rescind the contract and get damages for its breach. How should the court rule?
10. Buyers contracted to purchase a house being constructed by Contractor. The contract contained this clause: "Contractor shall pay to the owners or deduct from the total contract price $100.00 per day as liquidated damages for each day after said date that the construction is not completed and accepted by the Owners and Owners shall not arbitrarily withhold acceptance." Testimony established the rental value of the home at $400–$415 per month. Is the clause enforceable?

SELF-TEST QUESTIONS

1. Contract remedies protect
    1. a restitution interest
    2. a reliance interest
    3. an expectation interest
    4. all of the above
2. A restitution interest is
    1. the benefit for which the promisee bargained
    2. the loss suffered by relying on the contract
    3. that which restores any benefit one party conferred on the other
    4. none of the above
3. When breach of contract caused no monetary loss, the plaintiff is entitled to
    1. special damages
    2. nominal damages
    3. consequential damages
    4. no damages
4. Damages attributable to losses that flow from events that do not occur in the ordinary course of events are
    1. incidental damages
    2. liquidated damages
    3. consequential damages
    4. punitive damages
5. Restitution is available
    1. when the contract was avoided because of incapacity
    2. when the other party breached
    3. when the party seeking restitution breached
    4. all of the above

SELF-TEST AnswerS

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

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16: INTRODUCTION TO SALES AND LEASES

Learning Objectives

After reading this chapter, you should understand the following:

1. Why the law of commercial transactions is separate from the common law
2. What is meant by “commercial transactions” and how the Uniform Commercial Code (UCC) deals with them in general
3. The scope of Article 2, Article 2A, and the Convention on Contracts for the International Sale of Goods
4. What obligations similar to the common law’s are imposed on parties to a UCC contract, and what obligations different from the common law’s are imposed
5. The difference between a consumer lease and a finance lease

16.1: Commercial Transactions- the Uniform Commercial Code

16.2: Introduction to Sales and Lease Law, and the Convention on Contracts for the International Sale of Goods

16.3: Sales Law Compared with Common-Law Contracts and the CISG

16.4: General Obligations under UCC Article 2

16.5: Cases

16.6: Summary and Exercises

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16.1: Commercial Transactions- the Uniform Commercial Code

LEARNING OBJECTIVES

1. Understand why there is a separate body of law governing commercial transactions.
2. Be aware of the scope of the Uniform Commercial Code.
3. Have a sense of this text's presentation of the law of commercial transactions.

History of the UCC

In Chapter 7, *Introduction to Contract Law*, we briefly introduced the Uniform Commercial Code (UCC). The UCC has become a national law, adopted in every state—although Louisiana has not enacted Article 2—and there remain some differences from state to state. Of all the uniform laws designed to harmonize commercial transactions, the UCC is by far the most successful. Its history, however, stretches back centuries to the rise of commerce in medieval Europe.

In a mostly agricultural, self-sufficient society, there was little need for rules governing trade. Most law concerned land—its sale, lease, inheritance, and use—and disputes involving damages to land or services performed on it. By contrast, trade in goods was minimal, and what trade existed was largely in the hands of foreigners.

The Black Death of 1348–49 changed that picture. With 30 to 40 percent of England's population gone, feudal manors broke down. Labor shortages meant people could leave estates in search of better work, leading to migration into towns. Urban centers grew, and local needs could no longer be met entirely within the community. Surpluses in one area were traded for shortages in another. Ships, roads, money, weights and measures, accountants, and—crucially—merchants emerged as the backbone of a new commercial society.

Merchants wielded significant power. Through franchises granted by the crown, they created their own rules of law and enforced them in special mercantile courts. Fairs and staple towns had their own codes. Over time, these separate systems gave way to national governments, and mercantile customs were absorbed into national legal systems. Still, the "law merchant" lived on as a source of ideas and as a body of evolving practices shaping commercial law.

When the American colonies declared independence, they inherited English common law, including mercantile principles. By the early 20th century, however, commercial rules varied widely across the states, creating obstacles to interstate commerce. Several attempts at uniform laws failed to gain widespread adoption.

In 1942, the American Law Institute (ALI) undertook the ambitious project of drafting a unified, modern body of commercial law. The first draft of the UCC was completed in 1951, and Pennsylvania became the first state to adopt it in 1953. Other states quickly followed throughout the 1950s and 1960s.

The UCC has since been updated. In the 1980s, leasing of personal property became prominent, and Article 2A, governing leases of goods, was added in 1987. Article 2A largely parallels Article 2 but applies to leases rather than sales. In 2001, amendments to Article 1 (general provisions) were approved, and over half the states have since adopted them. In 2003, the ALI proposed modernizing amendments to Articles 2 and 2A, but no state has yet adopted them.

In short, the UCC represents centuries of commercial evolution—from medieval fairs and mercantile courts to a national code designed to harmonize American commerce.

Scope of the UCC

The UCC embraces the law of **commercial transactions**, broadly understood. A single commercial deal may involve multiple steps: contracting for the sale of goods, issuing or endorsing checks, shipping under a bill of lading, storing goods under warehouse receipts, and more. The UCC treats these not as isolated acts but as interconnected facets of one overall transaction.

The UCC is organized into the following articles:

- **Sales (Article 2)**
- **Leases (Article 2A)**
- **Commercial Paper (Article 3)**
- **Bank Deposits and Collections (Article 4)**
- **Funds Transfers (Article 4A)**
- **Letters of Credit (Article 5)**
- **Bulk Transfers (Article 6)**
- **Warehouse Receipts, Bills of Lading, and Other Documents of Title (Article 7)**
- **Investment Securities (Article 8)**
- **Secured Transactions; Sales of Accounts and Chattel Paper (Article 9)**

Although comprehensive, the UCC does not cover every area of commercial law. It excludes, for example, real property transactions, mortgages, insurance contracts, and most suretyship arrangements (unless tied to negotiable instruments). It also operates alongside common-law contract doctrines such as capacity, misrepresentation, coercion, and mistake. In addition, federal statutes like the Bills of Lading Act, the Consumer Credit Protection Act, and the Magnuson-Moss Warranty Act supersede portions of the UCC.

We now turn to the law of **sales**, the cornerstone of commercial transactions.

KEY TAKEAWAY

In the development of the English legal system, commercial transactions were originally of such little importance that the rules governing them were left to the merchants themselves. They had their own courts and adopted their own rules based on their customary usage. By the 1700s, the separate courts had been absorbed into the English common law, but the distinct rules applicable to commercial transactions remained and have carried over to the modern UCC. The UCC treats commercial transactions in phases, and this text basically traces those phases.

EXERCISES

1. Why were medieval merchants compelled to develop their own rules about commercial transactions?
2. Why was the UCC developed, and when was the period of its initial adoption by states?

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16.2: Introduction to Sales and Lease Law, and the Convention on Contracts for the International Sale of Goods

LEARNING OBJECTIVES

1. Understand that the law of sales not only incorporates many aspects of common-law contract but also addresses some distinct issues that do not occur in contracts for the sale of real estate or services.
2. Understand the scope of Article 2 and the definitions of *sale* and *goods*.
3. Learn how courts deal with hybrid situations: mixtures of the sale of goods and of real estate, mixtures of goods and services.
4. Recognize the scope of Article 2A and the definitions of *lease*, *consumer lease*, and *finance lease*.
5. Learn about the Convention on Contracts for the International Sale of Goods and why it is relevant to our discussion of Article 2.

Scope of Articles 2 and 2A and Definitions

In dealing with any statute, it is of course very important to understand the statute's scope or coverage.

Article 2 does not govern all commercial transactions, only sales. It does not cover all sales, only the sale of goods. Article 2A governs leases, but only of personal property (goods), not real estate. The Convention on Contracts for the International Sale of Goods (CISG)—kind of an international Article 2—"applies to contracts of sale of goods between parties whose places of business are in different States [i.e., countries]" (CISG, Article 1). So we need to consider the definitions of *sale*, *goods*, and *lease*.

Definition of *Sale*

A sale "consists in the passing of title from the seller to the buyer for a price" (UCC § 2-106).

Sales must be distinguished from related transactions:

- **Gifts.** A gift is the transfer of title without consideration. A promise to make a gift of goods is unenforceable under the UCC (with limited exceptions).
- **Bailments.** A bailment involves transfer of possession, but not title or use. For example, parking your car in a commercial garage often creates a bailment relationship.
- **Leases.** A lease is a fixed-term arrangement for possession and use of goods. Title remains with the lessor. (See "Definition of Lease" below.)
- **Secured transactions.** Here, an owner-debtor gives a creditor a security interest in collateral, allowing repossession if the debtor defaults. This is governed by Article 9.

Definition of *Goods*

Even if a transaction is a sale, Article 2 applies only if the subject is **goods**. Section 2-105(1) defines goods as "all things...which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid." Money itself may be treated as goods if it is the object of the contract (for example, a contract to sell foreign currency).

Two common questions arise in borderline cases:

1. Is the contract for the sale of the real estate, or is it for the sale of goods?
2. Is the contract for the sale of goods, or is it for services?

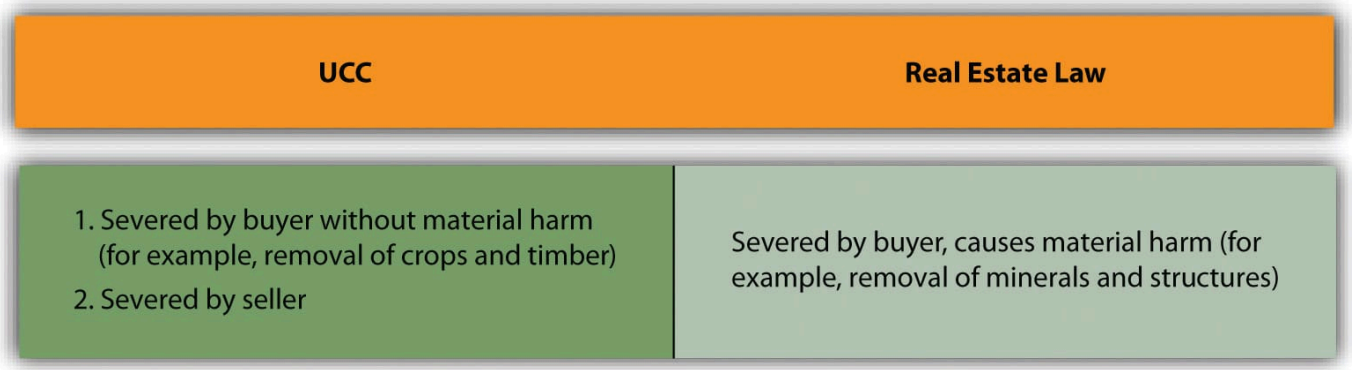
Real Estate versus Goods

The dilemma is this: A landowner enters into a contract to sell crops, timber, minerals, oil, or gas. If the items have already been

detached from the land—for example, timber has been cut and the seller agrees to sell logs—they are goods, and the UCC governs the sale. But what if, at the time the contract is made, the items are still part of the land? Is a contract for the sale of uncut timber governed by the UCC or by real estate law?

The UCC governs under either of two circumstances: (1) if the contract calls for the seller to sever the items or (2) if the contract calls for the buyer to sever the items and if the goods can be severed without material harm to the real estate.Uniform Commercial Code, Section 2-107. The second provision specifically includes growing crops and timber. By contrast, the law of real property governs if the buyer's severance of the items will materially harm the real estate; for example, the removal of minerals, oil, gas, and structures by the buyer will cause the law of real property to govern. (See Figure 17.1.)

Figure 17.1 Governing Law



Goods versus Services

Distinguishing goods from services is one of the most frequent challenges in applying Article 2. Many contracts are "mixed," involving both goods and services—for example, the sale and installation of a home water heater, or the purchase of a computer system with technical support included.

Courts typically apply the **predominant factor test** (also called the "predominant purpose" or "thrust" test): Was the contract primarily for goods with services incidental, or primarily for services with goods incidental? If goods predominate, the UCC applies; if services predominate, it does not.

Examples:

- **Predominantly goods:** A homeowner contracts with a store to buy kitchen cabinets, and the price includes delivery and installation. Because the essence of the contract is the sale of the cabinets, with installation incidental, Article 2 applies.
- **Predominantly services:** A hospital patient contracts for surgery, and the surgeon uses sutures and other medical supplies. Here, the essence of the agreement is the medical service; the goods are incidental. The UCC does not apply.
- **Case law illustrations:**
  - In *Epstein v. Giannattasio*, a beauty treatment was held to be a service contract because the cosmetics applied were incidental.
  - In *Newmark v. Gimble's, Inc.*, by contrast, a permanent wave lotion applied at a salon was treated as a sale of goods for warranty purposes, because the product itself was central to the treatment.

Legislative carve-outs:
To avoid uncertainty, legislatures have sometimes clarified how mixed transactions should be classified. For example:

- Food served in restaurants is deemed a **sale of goods**, whether eaten on or off the premises.
- Blood transfusions in hospitals are deemed a **service**, not a sale of goods, in most states—limiting liability for tainted blood.

Definition of *Lease*

Section 2A-103(j) defines a lease as "a transfer of the right to possession and use of goods for a term in return for consideration." The **lessor** transfers the right to possession; the **lessee** receives it.

Example: Alice rents a party canopy from Equipment Supply. Equipment Supply is the lessor, and Alice is the lessee.

The UCC distinguishes two types of leases:

1. **Consumer leases.** A lease of goods to an individual for personal, family, or household use, where total lease payments are less than $25,000 (UCC § 2A-103(e)). Consumer lessees are granted special protections.
2. **Finance leases.** A three-party arrangement in which the lessor acquires the goods from a supplier to lease them to the lessee.
    - *Example:* Jack wants to lease a boom lift for a roof renovation. First Bank buys the lift from Equipment Supply and leases it to Jack. First Bank is the lessor, Jack is the lessee, and Equipment Supply is the supplier.

International Sales of Goods

The UCC governs sales within the United States, but international commerce raises the same problems that once plagued interstate trade: inconsistent laws. To address this, the **United Nations Convention on Contracts for the International Sale of Goods (CISG)** was drafted in Vienna in 1980 and has been adopted by more than seventy-six countries, including the United States and its major trading partners (but not the United Kingdom).

The CISG's scope (Article 1) covers contracts for the sale of goods between parties whose businesses are in different countries. It governs contract formation and the rights and obligations of sellers and buyers but does not address validity of contracts, enforceability of provisions, or issues of usage (Article 4).

It excludes sales:

- of goods for personal, family, or household use (unless the seller did not know of such use),
- by auction,
- on execution or by authority of law,
- of stocks, shares, securities, negotiable instruments, or money,
- of ships, vessels, hovercraft, or aircraft, and
- of electricity (Article 2).

Parties may exclude the CISG altogether or vary the effect of its provisions (Article 6).

Why CISG matters:

1. With globalization, the CISG is increasingly important in international trade, providing uniform rules to reduce legal barriers.
2. The CISG reflects a different legal tradition from Anglo-American common law, making comparison valuable for understanding diverse legal cultures.

KEY TAKEAWAY

Article 2 of the UCC deals with the sale of goods. *Sale* and *goods* have defined meanings. Article 2A of the UCC deals with the leasing of goods. *Lease* has a defined meaning, and the UCC recognizes two types of leases: consumer leases and finance leases. Similar in purpose to the UCC of the United States is the Convention on Contracts for the International Sale of Goods, which has been widely adopted around the world.

EXERCISES

1. Why is there a separate body of statutory law governing contracts for the sale of goods as opposed to the common law, which governs contracts affecting real estate and services?
2. What is a consumer lease? A finance lease?

3. What is the Convention on Contracts for the International Sale of Goods?

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16.3: Sales Law Compared with Common-Law Contracts and the CISG

LEARNING OBJECTIVE

1. Recognize the differences and similarities among the Uniform Commercial Code (UCC), common-law contracts, and the CISG as related to the following contract issues:
   - Offer and acceptance
   - Revocability
   - Consideration
   - The requirement of a writing and contractual interpretation (form and meaning)

Sales law deals with the sale of goods. Sales law is a special type of contract law, but the common law informs much of Article 2 of the UCC—with some differences, however. Some of the similarities and differences were discussed in previous chapters that covered common-law contracts, but a review here is appropriate, and we can refer briefly to the CISG's treatment of similar issues.

Mutual Assent: Offer and Acceptance

Definiteness of the Offer

One important distinction between the common law and the Uniform Commercial Code (UCC) concerns the level of definiteness required in an agreement.

At common law, an offer must include all essential terms—such as price, subject matter, and quantity—with sufficient clarity. If an agreement is too indefinite, no contract is formed. For example, at common law, an agreement to sell goods "at a price to be agreed later" would almost always fail.

Under the UCC, the standard is more flexible. Section 2-204(3) provides that a contract for the sale of goods is not void for indefiniteness if (1) the parties intended to make a contract, and (2) there is a reasonably certain basis for giving an appropriate remedy. In other words, open terms do not necessarily prevent a binding contract.

Open Price Term

The most important example is the **open price term**, governed by UCC § 2-305.

- If the contract says nothing about price,
- Or if the parties agree to set the price later but fail to do so,
- Or if the price is to be fixed by a third party who does not act,

then the Code "plugs" the gap: the price is a **reasonable price at the time for delivery** (§ 2-305(1)).

When the contract gives one party the power to fix the price, § 2-305(2) requires that the price be set **in good faith**.

Example: Seller agrees to deliver 500 bushels of wheat to Buyer, with price "to be agreed upon later." When delivery is due, Seller demands $8 per bushel, while the market price is $6. Under the UCC, a contract still exists, and Buyer must pay a reasonable price—here, $6 per bushel—so long as the parties intended to be bound.

Exception: If the agreement makes clear that the parties do not intend to be bound unless the price is fixed or agreed upon, then no contract results (§ 2-305(4)).

Open Terms of Performance

The UCC also tolerates open terms as to performance. Section 2-311(1) provides that a contract is not invalid merely because it leaves details of performance—such as delivery arrangements or shipping methods—to be specified later by one of the parties. The only requirement is that such specifications must be made **in good faith** and within the bounds of **commercial reasonableness**.

Example: A buyer agrees to purchase 1,000 T-shirts from a seller, "delivery details to be specified later." When the buyer later directs delivery to a reasonable commercial location, the contract is enforceable even though delivery terms were initially open.

International Rule under the CISG

The **Convention on Contracts for the International Sale of Goods (CISG)** takes a stricter approach. Article 14 provides that a proposal constitutes an offer only if it is **sufficiently definite** and indicates the offeror's intent to be bound upon acceptance. A proposal is "sufficiently definite" only if it identifies the goods and expressly or implicitly provides for determining both the **quantity** and the **price**.

Thus, under the CISG, contracts with open price terms are far less likely to be enforceable than under the UCC.

Offer and Acceptance: Battle of the Forms

The concepts of **offer** and **acceptance** are central to contract formation. But the Uniform Commercial Code (UCC) departs from the common law in its treatment of an acceptance that varies from the offer—a frequent problem in commercial transactions involving preprinted **form contracts**.

Common Law: The Mirror Image Rule

At common law, the **mirror image rule** governs: an acceptance must exactly match the terms of the offer. If the acceptance introduces new or different terms, it is treated as a **counteroffer**, not an acceptance.

Example: Buyer offers to purchase 100 chairs for $50 each, delivery in 30 days. Seller replies, "I accept, but delivery in 60 days." Under the mirror image rule, no contract is formed; Seller's response is a counteroffer.

In modern commerce, where buyers and sellers routinely exchange conflicting purchase orders and invoices, strict application of the mirror image rule would render many transactions unenforceable.

UCC § 2-207: Relaxing the Rule

Section 2-207 was designed to resolve this **"battle of the forms."**

- **General Rule.** A written or oral expression of acceptance operates as an acceptance even though it states additional or different terms—unless acceptance is expressly conditioned on assent to those terms.
- **Between merchants.** Additional terms in an acceptance become part of the contract unless:
  1. The offer expressly limits acceptance to its own terms,
  2. The additional terms materially alter the contract, or
  3. The offeror objects within a reasonable time.
- **Conduct can form a contract.** Even if the writings of the parties do not align, conduct recognizing the existence of a contract (such as delivering and accepting goods) is enough to establish one. In that case, the contract consists of the agreed-upon terms plus UCC "gap-fillers."

Example: Buyer's purchase order requires arbitration in New York; Seller's acceptance form requires litigation in California. The parties proceed with shipment and payment. A contract exists by conduct, but the conflicting dispute-resolution terms cancel each other out. The gap is filled by the UCC or general law.

Note: Section 2-207 has been criticized as one of the most confusing parts of the UCC. Professor Grant Gilmore famously called it "arguably the greatest statutory mess of all time." Efforts to revise § 2-207 in 2003 failed, and no state has adopted the revision.

International Contracts: CISG Article 19

The **Convention on Contracts for the International Sale of Goods (CISG)** takes a similar but slightly stricter approach:

1. A reply that contains modifications is a **counteroffer**, not an acceptance.
2. However, if the modifications do not **materially alter** the offer, the reply is still an acceptance—unless the offeror objects without undue delay.
3. Terms relating to **price, payment, quality, quantity, delivery, liability, or dispute resolution** are deemed to **materially alter** an offer.

Example: Buyer offers to buy 500 tons of steel at $400 per ton, delivery in May. Seller replies, "I accept, delivery in June." Under the CISG, this change in delivery date is material, so the reply is a counteroffer—not an acceptance.

Summary.

- **Common law:** Acceptance must mirror the offer exactly, or it is a counteroffer.
- **UCC:** Acceptance may include different or additional terms; a contract can still be formed, even by conduct.
- **CISG:** Similar to the UCC but explicitly deems many kinds of changes "material," making counteroffers more likely.

Revocation of Offer

A fundamental principle of contract law is that an **offer may generally be revoked at any time prior to acceptance.** The law, however, recognizes important exceptions that limit the offeror's ability to withdraw an offer once made.

Common Law

Under the common law, an offer is freely revocable until accepted—**unless** the offeree has purchased an **option contract**.

- An option contract is a separate agreement, supported by consideration, in which the offeror promises to keep the offer open for a specified time.
- Without consideration, a promise to hold an offer open is not binding.

Example: Seller offers to sell land to Buyer for $100,000, promising to hold the offer open for 30 days. Unless Buyer gives consideration (say, $500) for this option, Seller may revoke the offer before acceptance.

UCC: Firm Offers

The UCC provides an additional rule for **merchants.** Section 2-205 allows a merchant to make a **firm offer**:

- A signed written offer by a merchant that gives assurances it will be held open is **irrevocable**, even without consideration.
- The offer remains irrevocable for the time stated, or if no time is stated, for a reasonable period not exceeding three months.

Example: A car dealer (a merchant) signs a written offer to sell a car for $20,000, stating it will remain open for 60 days. Buyer need not pay consideration to keep the offer open; it is binding for 60 days.

CISG: Article 17

The **Convention on Contracts for the International Sale of Goods (CISG)** blends elements of both approaches. Article 17

provides that an offer is revocable before acceptance **unless**:

1. The offer indicates that it is irrevocable (e.g., "This offer is firm until June 30"), or
2. The offeree reasonably relied on the offer's irrevocability.

Example: A German manufacturer offers to sell equipment to a U.S. buyer, stating, "This offer is valid until July 1." Under the CISG, the offer is irrevocable until that date. Even if no such statement is made, if the buyer reasonably relies on the offer being held open (e.g., incurs expenses preparing to perform), the offer may also be deemed irrevocable.

Reality of Consent

A contract is only enforceable if the parties entered into it with **genuine consent**. If consent is impaired—by duress, misrepresentation, undue influence, or mistake—the contract may be void or voidable.

Common Law and the UCC

On these issues, there is no significant difference between the **common law** and the **UCC**. Both systems recognize that a contract requires free and voluntary consent. Where consent is tainted:

- **Duress.** A contract entered into under wrongful threats (e.g., "sign this contract or we will harm your business") is voidable.
- **Misrepresentation or fraud.** If one party is induced into a contract by false statements of fact, the contract may be rescinded, and damages may be available.
- **Undue influence.** Contracts obtained by exploiting a position of trust or dominance (such as a caretaker pressuring an elderly person) may be set aside.
- **Mistake.** A mutual mistake of fact (e.g., both parties believe a horse is alive when it is already dead) may render a contract voidable.

Thus, under both common law and the UCC, the doctrines protecting the **reality of consent** remain essentially the same.

International Sales Contracts: CISG

The **CISG** takes a different approach. Article 4(a) explicitly states that the Convention "governs only the formation of the contract of sale and the rights and obligations of the seller and the buyer arising from such a contract and is not concerned with the validity of the contract or of any of its provisions."

This means issues such as duress, misrepresentation, undue influence, or mistake are **outside the scope of the CISG**. Instead, these matters are left to the **domestic law** of the country whose rules apply under the governing conflict-of-law principles.

Example: If a French seller defrauds a U.S. buyer in an international sale governed by the CISG, the buyer may use the CISG for issues of performance and remedies, but must rely on U.S. or French law (depending on the conflict rules) to challenge the contract's validity on grounds of fraud.

Consideration

Common Law

At common law, consideration is required not only for the **formation** of a contract but also for any **modification** or **discharge** of obligations.

- **Modification.** A contract cannot be modified without new consideration. For example, if a builder demands an additional $10,000 to complete a house already under contract, the homeowner's promise to pay is unenforceable unless the builder gives something additional in return.
- **Discharge.** Forgiving a breach requires consideration. A landlord, for instance, who wishes to forgive a tenant's late rent must

receive something in exchange for this waiver.
- **Options.** A promise to keep an offer open requires consideration (usually a payment), creating an option contract.

The UCC

The UCC softens the consideration requirement in several key areas:

- **Modification.** Section 2-209(1) provides that no consideration is required for a good-faith modification of a sales contract. A seller and buyer can agree to change delivery terms or prices without additional consideration, so long as the change is made in good faith.
- **Waiver or renunciation.** Section 1-107 allows an aggrieved party to forgive a breach through a written waiver, without requiring consideration. For example, a buyer may excuse a late delivery by signing a written waiver.
- **Firm offers.** Section 2-205 allows a merchant to make a "firm offer" in writing that is irrevocable for a specified time (up to three months), without consideration. This differs from the common law rule that an option contract requires consideration.

Example: A merchant promises in a signed writing to sell 1,000 widgets at $5 each, keeping the offer open for 60 days. Even without consideration, the promise is enforceable under the UCC as a firm offer.

The CISG

The **CISG** goes even further, effectively discarding consideration altogether. Article 29 provides: "A contract may be modified or terminated by the mere agreement of the parties."

- No consideration is required for contract formation, modification, or discharge.
- Parties are free to adjust or cancel their agreements simply by mutual consent.

Example: A French seller and U.S. buyer agree to reduce the purchase quantity under an existing CISG-governed contract. No additional consideration is needed; the mutual agreement alone suffices.

Form and Meaning

Requirement of a Writing

At common law, the **Statute of Frauds** requires certain contracts to be in writing to be enforceable. These include:

- Contracts for the sale of **real property**,
- Contracts made in consideration of **marriage**,
- Contracts not performable within one year, and
- Suretyship agreements (a promise to pay the debt of another).

The UCC

The UCC adopts its own Statute of Frauds for sales contracts.

- **Section 2-201** requires a writing for contracts for the **sale of goods priced at $500 or more.**
- The writing need not be a formal contract; a signed memorandum indicating that a contract exists is sufficient.
- There are important **exceptions**, such as contracts for specially manufactured goods, admissions in court, or where part performance has occurred (discussed in Chapter 13).
- In 2003, UCC revisioners proposed raising the threshold to **$5,000** to reflect inflation since the 1950s. However, **no state has adopted this amendment.**

Example: A contract to sell 100 laptops for $1,000 each must be in writing to be enforceable. A contract to sell a single used

printer for $200 does not.

The CISG

The CISG takes a much more flexible approach.

- **Article 11** provides: "A contract of sale need not be concluded in or evidenced by writing and is not subject to any other requirement as to form. It may be proved by any means, including witnesses."
- This eliminates any Statute of Frauds requirement for international sales contracts.
- However, **Article 29** adds an important caveat: if a written contract contains a clause requiring modifications or terminations to be in writing, that clause is enforceable.

Example: A U.S. buyer and a German seller orally agree to purchase $100,000 worth of machinery. Under the CISG, the contract is enforceable even without a writing. But if their written contract specifies that "all modifications must be in writing," an oral change in delivery date would not be valid.

Parol Evidence

When parties reduce their agreement to a final written form, the question arises: may one party later introduce evidence of earlier or contemporaneous agreements to add to, vary, or contradict the writing? This is governed by the **parol evidence rule**.

Common Law

At common law, if the parties intended a writing to be the **final expression** of their agreement, it cannot be contradicted by evidence of prior or contemporaneous oral agreements. However, courts may allow evidence to **explain ambiguities** or to show fraud, duress, or mistake.

The UCC

The UCC largely adopts the common law rule but provides greater flexibility.

- **Section 2-202** states that if the parties have a writing intended to be their final agreement, it "may not be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement."
- However, such a writing **may be explained or supplemented** by:
  1. **Course of dealing** (prior transactions between the parties),
  2. **Usage of trade** (industry customs),
  3. **Course of performance** (how the parties have behaved under the current contract), and
  4. **Evidence of consistent additional terms** (so long as the writing was not intended as a complete and exclusive statement of the agreement).

Example: A buyer and seller have a written contract for delivery of "chicken." Evidence that, in the poultry trade, "chicken" typically means "broilers, not stewing hens" may be admissible to explain the term.

The CISG

The CISG does not adopt a parol evidence rule in the same form. Instead, **Article 8** provides that in determining a party's intent, "due consideration is to be given to all relevant circumstances of the case including the negotiations, any practices which the parties have established between themselves, usages, and any subsequent conduct of the parties."

This reflects a more liberal approach:

- Negotiations and subsequent conduct are always admissible to interpret the agreement.
- Rather than excluding prior statements, the CISG emphasizes a contextual inquiry into what a reasonable person in the parties' position would have understood.

KEY TAKEAWAY

The UCC modernizes and simplifies some common-law strictures. Under the UCC, the mirror image rule is abolished: an acceptance may sometimes differ from the offer, and the UCC can "plug" open terms in many cases. No consideration is required under the UCC to modify or terminate a contract or for a merchant's "firm offer," which makes the offer irrevocable according to its terms. The UCC has a Statute of Frauds analogous to the common law, and its parol evidence rule is similar as well. The CISG compares fairly closely to the UCC.

EXERCISES

1. Why does the UCC change the common-law mirror image rule, and how?
2. What is meant by "open terms," and how does the UCC handle them?
3. The requirement for consideration is relaxed under the UCC compared with common law. In what circumstances is no consideration necessary under the UCC?
4. On issues so far discussed, is the CISG more aligned with the common law or with the UCC? Explain your answer.

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16.4: General Obligations under UCC Article 2

LEARNING OBJECTIVES

1. Know that the Uniform Commercial Code (UCC) imposes a general obligation to act in good faith and that it makes unconscionable contracts or parts of a contract unenforceable.
2. Recognize that though the UCC applies to all sales contracts, merchants have special obligations.
3. See that the UCC is the "default position"—that within limits, parties are free to put anything they want to in their contract.

Article 2 of the UCC of course has rules governing the obligations of parties specifically as to the offer, acceptance, performance of sales contracts, and so on. But it also imposes some general obligations on the parties. Two are called out here: one deals with unfair contract terms, and the second with obligations imposed on merchants.

Obligation of Good-Faith Dealings in General

Under the UCC

Contracts rest not only on written terms but also on the expectation that parties will deal with each other fairly. Both the **UCC** and the **common law** impose an obligation of **good faith** in the performance and enforcement of contracts, and the **CISG** includes a similar principle for international trade.

Common Law and the UCC

- **Common law.** The Restatement (Second) of Contracts § 205 provides: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."
- **UCC.** Section 1-203 echoes this, declaring that "every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." Section 2-103(j) defines good faith as "honesty in fact and the observance of reasonable commercial standards of fair dealing."

Thus, both systems recognize that the parties must act honestly and fairly in carrying out and enforcing their agreements.

Unconscionability

The UCC goes a step further. What if the **terms of the contract itself** are unfair? Section 2-302(1) gives courts power to strike down or modify contracts that are **unconscionable** at the time they were made:

> "If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made, the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result."

This grants courts significant flexibility: they may refuse to enforce the entire contract, delete an unfair clause, or limit the scope of the unfair provision.

But what does "unconscionable" mean? Section 2-302(1) gives only a circular definition, referring to whether the terms are "so one-sided as to be unconscionable" given the commercial context. The official comments explain that the principle is meant to prevent **oppression** and **unfair surprise**, not to disturb legitimate allocations of risk.

Courts have developed the concept into two categories:

1. **Procedural unconscionability**—an absence of meaningful choice in the bargaining process. *Example:* A consumer

pressured into signing a pre-printed form while being told, “Don’t worry about the fine print.”
2. **Substantive unconscionability**—terms that are unreasonably harsh or one-sided. *Example:* A clause requiring a buyer to forfeit all payments if even one installment is missed.

The leading case, *Williams v. Walker-Thomas Furniture Co.*, illustrates both forms, combining a high-pressure sales environment with a contract provision allowing repossession of all purchased goods if the buyer defaulted on a single payment.

Policy Impact

The doctrine of unconscionability has reshaped American contract law. Where courts once embraced **caveat emptor** (“let the buyer beware”), modern doctrine increasingly emphasizes **caveat venditor** (“let the seller beware”). Courts now invoke unconscionability not only in the sale of goods but also in consumer credit contracts, leases, and other contexts.

CISG

The **CISG** also recognizes good faith, though in more general terms. Article 7 provides:

> “Regard is to be had…to the observance of good faith in international trade.”

This reference emphasizes the expectation that parties engaged in international commerce will deal honestly and fairly, though the CISG leaves the details of unconscionability or unfairness to domestic law.

Obligations Owed by Merchants

The **UCC** applies broadly to sales of goods, whether casual or commercial. For example, it governs a simple sale of a used car between neighbors. However, the Code imposes **special obligations on merchants**, recognizing their greater experience and knowledge.

“Merchant” Sellers

Merchants are often held to higher standards than casual sellers. Because merchants are professionals, they are presumed to have knowledge of industry practices and commercial norms. Thus, rules that might burden an inexperienced seller apply comfortably to merchants.

Example: The UCC relaxes the mirror image rule “as between merchants,” meaning additional terms in an acceptance may become part of the contract automatically unless they materially alter it. Similarly, the **ten-day-reply doctrine** creates an exception to the Statute of Frauds for merchants who exchange signed writings (UCC §§ 2-205, 2A-205).

Merchant to Nonmerchant

Merchants also bear obligations when selling to **nonmerchants**. The most significant is the **implied warranty of merchantability**:

- A merchant warrants that the goods are fit for the ordinary purposes for which such goods are used.
- Nonmerchants make no such warranty, nor do merchants selling goods outside their normal line of business.

Example: A supermarket selling canned goods is a merchant in food products, but if it sells its used display cases, it is not a merchant in display cases and makes no implied warranty of merchantability.

In *Sheeskin v. Giant Foods, Inc.* (1974), a customer was injured when bottles of Coca-Cola exploded as he lifted a carton from the store’s display. The supermarket argued no sale had occurred because the customer had not yet paid. The court disagreed, holding that placing the item in the shopping cart was a “reasonable manner of acceptance” under UCC § 2-206(1). Thus, the

implied warranty of merchantability applied.

Who Is a Merchant?

The UCC defines a merchant in § 2-104(1) as one "who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction."

Key points:

- The phrase **"between merchants"** (UCC § 2-104(3)) refers to transactions where both parties have merchant-level knowledge.
- Not every businessperson is a merchant for every type of transaction. A car dealer is a merchant for cars but not for selling office furniture.
- Institutions can qualify as merchants if they employ agents or purchasing departments with the necessary expertise. For example, a university with a professional purchasing office may be treated as a merchant when entering into supply contracts.

Courts often face difficult policy questions in deciding merchant status. In *Goldkist, Inc. v. Brownlee*, the determination of whether the defendant was a merchant carried significant implications for liability and fairness in commercial practice.

Obligations May Be Determined by the Parties

The UCC provides **default rules**, but parties remain free to shape their obligations by contract. Section 1-102 states that the effect of UCC provisions may generally be varied by agreement. However, certain obligations—**good faith, diligence, reasonableness, and care**—cannot be waived. The parties may, though, set their own standards for measuring these duties, as long as those standards are not "manifestly unreasonable."

Example: If the contract is silent on the place of delivery, UCC § 2-308 supplies the term: delivery occurs at the seller's place of business (or residence if no business location exists).

The **CISG** follows a similar principle. Article 6 provides that "the parties may exclude the application of this Convention or...vary the effect of any of its provisions." This grants contracting parties broad freedom to design their agreements to suit their needs.

KEY TAKEAWAY

The UCC imposes some general obligations on parties to a sales contract. They must act in good faith, and unconscionable contracts or terms thereof will not be enforced. The UCC applies to any sale of goods, but sometimes special obligations are imposed on merchants. While the UCC imposes various general (and more specific) obligations on the parties, they are free, within limits, to make up their own contract terms and obligations; if they do not, the UCC applies. The CISG tends to follow the basic thrust of the UCC.

EXERCISES

1. What does the UCC say about the standard duty parties to a contract owe each other?
2. Why are merchants treated specially by the UCC in some circumstances?
3. Give an example of a merchant-to-merchant duty imposed by the UCC and of a merchant-to-nonmerchant duty.
4. What does it mean to say the UCC is the "default" contract term?

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16.5: Cases

Mixed Goods and Services Contracts: The “Predominant Factor” Test

Pittsley v. Houser

875 P.2d 232 (Idaho App. 1994)

Swanstrom, J.

In September of 1988, Jane Pittsley contracted with Hilton Contract Carpet Co. (Hilton) for the installation of carpet in her home. The total contract price was $4,402 [about $7,900 in 2010 dollars]. Hilton paid the installers $700 to put the carpet in Pittsley's home. Following installation, Pittsley complained to Hilton that some seams were visible, that gaps appeared, that the carpet did not lay flat in all areas, and that it failed to reach the wall in certain locations. Although Hilton made various attempts to fix the installation, by attempting to stretch the carpet and other methods, Pittsley was not satisfied with the work. Eventually, Pittsley refused any further efforts to fix the carpet. Pittsley initially paid Hilton $3,500 on the contract, but refused to pay the remaining balance of $902.

Pittsley later filed suit, seeking rescission of the contract, return of the $3,500 and incidental damages. Hilton answered and counterclaimed for the balance remaining on the contract. The matter was heard by a magistrate sitting without a jury. The magistrate found that there were defects in the installation and that the carpet had been installed in an unworkmanlike manner. The magistrate also found that there was a lack of evidence on damages. The trial was continued to allow the parties to procure evidence on the amount of damages incurred by Pittsley. Following this continuance, Pittsley did not introduce any further evidence of damages, though witnesses for Hilton estimated repair costs at $250.

Although Pittsley had asked for rescission of the contract and a refund of her money, the magistrate determined that rescission, as an equitable remedy, was only available when one party committed a breach so material that it destroyed the entire purpose of the contract. Because the only estimate of damages was for $250, the magistrate ruled rescission would not be a proper remedy. Instead, the magistrate awarded Pittsley $250 damages plus $150 she expended in moving furniture prior to Hilton's attempt to repair the carpet. On the counterclaim, the magistrate awarded Hilton the $902 remaining on the contract. Additionally, both parties had requested attorney fees in the action. The magistrate determined that both parties had prevailed and therefore awarded both parties their attorney fees.

Following this decision, Pittsley appealed to the district court, claiming that the transaction involved was governed by the Idaho Uniform Commercial Code (UCC), [Citation]. Pittsley argued that if the UCC had been properly applied, a different result would have been reached. The district court agreed with Pittsley's argument, reversing and remanding the case to the magistrate to make additional findings of fact and to apply the UCC to the transaction....

Hilton now appeals the decision of the district court. Hilton claims that Pittsley failed to allege or argue the UCC in either her pleadings or at trial. Even if application of the UCC was properly raised, Hilton argues that there were no defects in the goods that were the subject of the transaction, only in the installation, making application of the UCC inappropriate....

The single question upon which this appeal depends is whether the UCC is applicable to the subject transaction. If the underlying transaction involved the sale of “goods,” then the UCC would apply. If the transaction did not involve goods, but rather was for services, then application of the UCC would be erroneous.

Idaho Code § 28–2-105(1) defines “goods” as “all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale....” Although there is little dispute that carpets are “goods,” the transaction in this case also involved installation, a service. Such hybrid transactions, involving both goods and services, raise difficult questions about the applicability of the UCC. Two lines of authority have emerged to deal with such situations.

The first line of authority, and the majority position, utilizes the “predominant factor” test. The Ninth Circuit, applying the Idaho Uniform Commercial Code to the subject transaction, restated the predominant factor test as:

The test for inclusion or exclusion is not whether they are mixed, but, granting that they are mixed, whether their predominant factor, their thrust, their purpose, reasonably stated, is the rendition of service, with goods incidentally involved (e.g., contract with

artist for painting) or is a transaction of sale, with labor incidentally involved (e.g., installation of a water heater in a bathroom).

[Citations]. This test essentially involves consideration of the contract in its entirety, applying the UCC to the entire contract or not at all.

The second line of authority, which Hilton urges us to adopt, allows the contract to be severed into different parts, applying the UCC to the goods involved in the contract, but not to the non-goods involved, including services as well as other non-goods assets and property. Thus, an action focusing on defects or problems with the goods themselves would be covered by the UCC, while a suit based on the service provided or some other non-goods aspect would not be covered by the UCC....

We believe the predominant factor test is the more prudent rule. Severing contracts into various parts, attempting to label each as goods or non-goods and applying different law to each separate part clearly contravenes the UCC's declared purpose "to simplify, clarify and modernize the law governing commercial transactions." I.C. § 28–1–102(2)(a). As the Supreme Court of Tennessee suggested in [Citation], such a rule would, in many contexts, present "difficult and in some instances insurmountable problems of proof in segregating assets and determining their respective values at the time of the original contract and at the time of resale, in order to apply two different measures of damages."

Applying the predominant factor test to the case before us, we conclude that the UCC was applicable to the subject transaction. The record indicates that the contract between the parties called for "175 yds Masterpiece # 2122-Installed" for a price of $4319.50. There was an additional charge for removing the existing carpet. The record indicates that Hilton paid the installers $700 for the work done in laying Pittsley's carpet. It appears that Pittsley entered into this contract for the purpose of obtaining carpet of a certain quality and color. It does not appear that the installation, either who would provide it or the nature of the work, was a factor in inducing Pittsley to choose Hilton as the carpet supplier. On these facts, we conclude that the sale of the carpet was the predominant factor in the contract, with the installation being merely incidental to the purchase. Therefore, in failing to consider the UCC, the magistrate did not apply the correct legal principles to the facts as found. We must therefore vacate the judgment and remand for further findings of fact and application of the UCC to the subject transaction.

CASE QUESTIONS

1. You may recall in Chapter 15 "Discharge of Obligations" the discussion of the "substantial performance" doctrine. It says that if a common-law contract is not completely, but still "substantially," performed, the nonbreaching party still owes something on the contract. And it was noted there that under the UCC, there is no such doctrine. Instead, the "perfect tender" rule applies: the goods delivered by the seller must be exactly right. Does the distinction between the substantial performance doctrine and the perfect tender rule shed light on what difference applying the common law or the UCC would make in this case?
2. If Pittsley won on remand, what would she get?
3. In discussing the predominant factor test, the court here quotes from the Ninth Circuit, a *federal* court of appeals. What is a federal court doing making rules for a state court?

"Merchants" under the UCC

Goldkist, Inc. v. Brownlee

355 S.E.2d 773 (Ga. App. 1987)

Beasley, J.

The question is whether the two defendant farmers, who as a partnership both grew and sold their crops, were established by the undisputed facts as not being "merchants" as a matter of law, according to the definition in [Georgia UCC 2-104(1)]....

Appellees admit that their crops are "goods" as defined in [2-105]. The record establishes the following facts. The partnership had been operating the row crop farming business for 14 years, producing peanuts, soybeans, corn, milo, and wheat on 1,350 acres, and selling the crops.

It is also established without dispute that Barney Brownlee, whose deposition was taken, was familiar with the marketing procedure of "booking" crops, which sometimes occurred over the phone between the farmer and the buyer, rather than in person, and a written contract would be signed later. He periodically called plaintiff's agent to check the price, which fluctuated. If the price met his approval, he sold soybeans. At this time the partnership still had some of its 1982 crop in storage, and the price was

rising slowly. Mr. Brownlee received a written confirmation in the mail concerning a sale of soybeans and did not contact plaintiff to contest it but simply did nothing. In addition to the agricultural business, Brownlee operated a gasoline service station....

In dispute are the facts with respect to whether or not an oral contract was made between Barney Brownlee for the partnership and agent Harrell for the buyer in a July 22 telephone conversation. The plaintiff's evidence was that it occurred and that it was discussed soon thereafter with Brownlee at the service station on two different occasions, when he acknowledged it, albeit reluctantly, because the market price of soybeans had risen. Mr. Brownlee denies booking the soybeans and denies the nature of the conversations at his service station with Harrell and the buyer's manager....

Whether or not the farmers in this case are "merchants" as a matter of law, which is not before us, the evidence does not demand a conclusion that they are outside of that category which is excepted from the requirement of a signed writing to bind a buyer and seller of goods....To allow a farmer who deals in crops of the kind at issue, or who otherwise comes within the definition of "merchant" in [UCC] 2-104(1), to renege on a confirmed oral booking for the sale of crops, would result in a fraud on the buyer. The farmer could abide by the booking if the price thereafter declined but reject it if the price rose; the buyer, on the other hand, would be forced to sell the crop following the booking at its peril, or wait until the farmer decides whether to honor the booking or not.

Defendants' narrow construction of "merchant" would, given the booking procedure used for the sale of farm products, thus guarantee to the farmers the best of both possible worlds (fulfill booking if price goes down after booking and reject it if price improves) and to the buyers the worst of both possible worlds. On the other hand, construing "merchants" in [UCC] 2-104(1) as not excluding as a matter of law farmers such as the ones in this case, protects them equally as well as the buyer. If the market price declines after the booking, they are assured of the higher booking price; the buyer cannot renege, as [UCC]2-201(2) would apply.

In giving this construction to the statute, we are persuaded by [Citation], supra, and the analyses provided in the following cases from other states: [Citations]. By the same token, we reject the narrow construction given in other states' cases: [Citations]. We believe this is the proper construction to give the two statutes, [UCC 2-104(1) and 2-201(2)], as taken together they are thus further branches stemming from the centuries-old simple legal idea *pacta servanda sunt*—agreements are to be kept. So construed, they evince the legislative intent to enforce the accepted practices of the marketplace among those who frequent it.

Judgment reversed. [Four justices concurred with Justice Beasley].

Benham, J., dissenting.

Because I cannot agree with the majority's conclusion that appellees are merchants, I must respectfully dissent.

...The validity of [plaintiff's] argument, that sending a confirmation within a reasonable time makes enforceable a contract even though the statute of frauds has not been satisfied, rests upon a showing that the contract was "[b]etween merchants." "Between merchants" is statutorily defined in the Uniform Commercial Code as meaning "any transaction with respect to which both parties are chargeable with the knowledge or skill of merchants" [2-104(3)]. "'Merchant' means a person [1] who deals in goods of the kind or [2] otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or [3] to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill" [Citation]. Whether [plaintiff] is a merchant is not questioned here; the question is whether, under the facts in the record, [defendant]/farmers are merchants....

The Official Comment to § 2-104 of the U.C.C. (codified in Georgia)...states: "This Article assumes that transactions between professionals in a given field require special and clear rules which may not apply to a casual or inexperienced seller or buyer...This section lays the foundation of this policy by defining those who are to be regarded as professionals or 'merchants' and by stating when a transaction is deemed to be 'between merchants.' The term 'merchant' as defined here roots in the 'law merchant' concept of a professional in business." As noted by the Supreme Court of Kansas in [Citation] (1976): "The concept of professionalism is heavy in determining who is a merchant under the statute. The writers of the official UCC comment virtually equate professionals with merchants—the casual or inexperienced buyer or seller is not to be held to the standard set for the professional in business. The defined term 'between merchants,' used in the exception proviso to the statute of frauds, contemplates the knowledge and skill of professionals on each side of the transaction." The Supreme Court of Iowa [concurs in cases cited]. Where, as here, the undisputed evidence is that the farmer's sole experience in the marketplace consists of selling the crops he has grown, the courts of several of our sister states have concluded that the farmer is not a merchant. [Citations]. Just because appellee Barney Brownlee kept "conversant with the current price of [soybeans] and planned to market it to his advantage does not necessarily make him a 'merchant.' It is but natural for anyone who desires to sell anything he owns to negotiate and get the best price obtainable. If this would make one a 'merchant,' then practically anyone who sold anything would be deemed a merchant, hence

would be an exception under the statute[,] and the need for a contract in writing could be eliminated in most any kind of a sale." [Citation].

It is also my opinion that the record does not reflect that appellees "dealt" in soybeans, or that through their occupation, they held themselves out as having knowledge or skill peculiar to the practices or goods involved in the transaction. See [UCC] 2-104(1). "[A]lthough a farmer may well possess special knowledge or skill with respect to the production of a crop, the term 'merchant,' as used in the Uniform Commercial Code, contemplates special knowledge and skill associated with the marketplace. As to the area of farm crops, this special skill or knowledge means, for instance, special skill or knowledge associated with the operation of the commodities market. It is inconceivable that the drafters of the Uniform Commercial Code intended to place the average farmer, who merely grows his yearly crop and sells it to the local elevator, etc., on equal footing with the professional commodities dealer whose sole business is the buying and selling of farm commodities" [Citations]. If one who buys or sells something on an annual basis is a merchant, then the annual purchaser of a new automobile is a merchant who need not sign a contract for the purchase in order for the contract to be enforceable....

If these farmers are not merchants, a contract signed by both parties is necessary for enforcement. If the farmer signs a contract, he is liable for breach of contract if he fails to live up to its terms. If he does not sign the contract, he cannot seek enforcement of the terms of the purchaser's offer to buy....

Because I find no evidence in the record that appellees meet the statutory qualifications as merchants, I would affirm the decision of the trial court. I am authorized to state that [three other justices] join in this dissent.

CASE QUESTIONS

1. How is the UCC's ten-day-reply doctrine in issue here?
2. Five justices thought the farmers here should be classified as "merchants," and four of them thought otherwise. What argument did the majority have against calling the farmers "merchants"? What argument did the dissent have as to why they should not be called merchants?
3. Each side marshaled persuasive precedent from other jurisdictions to support its contention. As a matter of public policy, is one argument better than another?
4. What does the court mean when it says the defendants are not excluded from the definition of merchants "as a matter of law"?

Unconscionability in Finance Lease Contracts

Info. Leasing Corp. v. GDR Investments, Inc.

787 N.E.2d 652 (Ohio App. 2003)

Gorman, J.

The plaintiff-appellant, Information Leasing Corporation ("ILC"), appeals from the order of the trial court rendering judgment in favor of the defendants-appellees...GDR Investments, Inc. [defendant Arora's corporation], Pinnacle Exxon, and Avtar S. Arora, in an action to recover $15,877.37 on a five-year commercial lease of an Automated Teller Machine ("ATM")....

This is one of many cases involving ILC that have been recently before this court. ILC is an Ohio corporation wholly owned by the Provident Bank. ILC is in the business of leasing ATMs through a third party, or vendor. In all of these cases, the vendor has been...Credit Card Center ("CCC"). CCC was in the business of finding lessees for the machines and then providing the services necessary to operate them, offering the lessees attractive commissions. Essentially, CCC would find a customer, usually a small business interested in having an ATM available on its premises, arrange for its customer to sign a lease with ILC, and then agree to service the machine, keeping it stocked with cash and paying the customer a certain monthly commission. Usually, as in the case of [defendants], the owner of the business was required to sign as a personal guarantor of the lease. The twist in this story is that CCC soon went bankrupt, leaving its customers stuck with ATMs under the terms of leases with ILC but with no service provider. Rather than seeking to find another company to service the ATMs, many of CCC's former customers, like [defendants], simply decided that they no longer wanted the ATMs and were no longer going to make lease payments to ILC. The terms of each lease, however, prohibited cancellation. The pertinent section read,

LEASE NON-CANCELABLE AND NO WARRANTY. THIS LEASE CANNOT BE CANCELED BY YOU FOR ANY REASON, INCLUDING EQUIPMENT FAILURE, LOSS OR DAMAGE. YOU MAY NOT REVOKE ACCEPTANCE OF THE EQUIPMENT. YOU, NOT WE,

SELECTED THE EQUIPMENT AND THE VENDOR. WE ARE NOT RESPONSIBLE FOR EQUIPMENT FAILURE OR THE VENDOR'S ACTS. YOU ARE LEASING THE EQUIPMENT 'AS IS', [sic] AND WE DISCLAIM ALL WARRANTIES, EXPRESS OR IMPLIED. WE ARE NOT RESPONSIBLE FOR SERVICE OR REPAIRS.

Either out of a sense of fair play or a further desire to make enforcement of the lease ironclad, ILC put a notice on the top of the lease that stated,

NOTICE: THIS IS A NON-CANCELABLE, BINDING CONTRACT. THIS CONTRACT WAS WRITTEN IN PLAIN LANGUAGE FOR YOUR BENEFIT. IT CONTAINS IMPORTANT TERMS AND CONDITIONS AND HAS LEGAL AND FINANCIAL CONSEQUENCES TO YOU. PLEASE READ IT CAREFULLY; FEEL FREE TO ASK QUESTIONS BEFORE SIGNING BY CALLING THE LEASING COMPANY AT 1-513-421-9191.

Arora, the owner of [defendant corporation], was a resident alien with degrees in commerce and economics from the University of Delhi, India. Arora wished to have an ATM on the premises of his Exxon station in the hope of increasing business. He made the mistake of arranging acquisition of the ATM through CCC. According to his testimony, a representative of CCC showed up at the station one day and gave him "formality papers" to sign before the ATM could be delivered. Arora stated that he was busy with other customers when the CCC representative asked him to sign the papers. He testified that when he informed the CCC representative that he needed time to read the documents before signing them, he was told not to worry and...that the papers did not need his attention and that his signature was a mere formality. Arora signed the ILC lease, having never read it.

Within days, CCC went into bankruptcy. Arora found himself with an ATM that he no longer wanted....According to his testimony, he tried unsuccessfully to contact ILC to take back the ATM. Soon Arora suffered a mild heart attack, the gas station went out of business, and the ATM, which had been in place for approximately eighteen days, was left sitting in the garage, no longer in use until ILC came and removed it several months later.

Unfortunately for Arora, the lease also had an acceleration clause that read,

DEFAULT. If you fail to pay us or perform as agreed, we will have the right to (i) terminate this lease, (ii) sue you for all past due payment AND ALL FUTURE PAYMENTS UNDER THIS LEASE, plus the Residual Value we have placed on the equipment and other charges you owe us, (iii) repossess the equipment at your expense and (iv) exercise any other right or remedy which may be available under applicable law or proceed by court act.

The trial court listened to the evidence in this case, which was awkwardly presented due in large part to Arora's decision to act as his own trial counsel. Obviously impressed with Arora's honesty and sympathetic to his situation, the trial court found that Arora owed ILC nothing. In so ruling, the court stated that ILC "ha[d] not complied with any of its contractual obligations and that [Arora] appropriately canceled any obligations by him, if there really were any." The court also found that ILC, "if they did have a contract, failed to mitigate any damages by timely picking up the machine after [Arora] gave them notice to pick up the machine."...

ILC contends, and we do not disagree, that the lease in question satisfied the definition of a "finance lease" under [UCC 2A-407]. A finance lease is considerably different from an ordinary lease in that it adds a third party, the equipment supplier or manufacturer (in this case, the now defunct CCC). As noted by White and Summers, "In effect, the finance lessee * * * is relying upon the manufacturer * * * to provide the promised goods and stand by its promises and warranties; the [lessee] does not look to the [lessor] for these. The [lessor] is only a finance lessor and deals largely in paper, rather than goods." [Citation].

One notorious feature of a finance lease is its typically noncancelable nature, which is specifically authorized by statute [UCC 2A-407]. [UCC 2A-407(1)] provides in the case of a finance lease that is not a consumer lease, "[T]he lessee's promises under the lease contract become irrevocable and independent upon the lessee's acceptance of the goods." The same statutory section also makes clear that the finance lease is "not subject to cancellation, termination, modification, repudiation, excuse, or substitution without the consent of the party to whom it runs." [Citation]

Because of their noncancelable nature, finance leases enjoy somewhat of a reputation. The titles of law review articles written about them reveal more than a little cynicism regarding their fairness: [Citations].

...As described by Professors White and Summers, "The parties can draft a lease agreement that carefully excludes warranty and promissory liability of the finance lessor to the lessee, and that sets out what is known in the trade as a 'hell or high water clause,' namely, a clause that requires the lessee to continue to make rent payments to the finance lessor even though the [equipment] is unsuitable, defective, or destroyed."..."The lessor's responsibility is merely to provide the money, not to instruct the lessee like a wayward child concerning a suitable purchase * * *. Absent contrary agreement, even if [, for example, a finance-leased] Boeing

747 explodes into small pieces in flight and is completely uninsured, lessee's obligation to pay continues."

...Some people complain about being stuck with the bill; Arora's complaint was that he was stuck with the ATM....

To begin the proper legal analysis, we note first that this was not a "consumer lease" expressly excepted from [UCC 2A-407]. A "consumer lease" is defined in [UCC 2A-103(e)] as one in which the lessee is "an individual and who takes under the lease primarily for a personal, family, or household purpose." This would definitely not apply here, where the ATM was placed on the business premises of the Exxon station, and where the lessee was [Arora's corporation] and not Arora individually. (Arora was liable individually as the personal guarantor of [his corporation]'s obligations under the lease.)...

Certain defenses do remain, however. First, the UCC expressly allows for the application of the doctrine of unconscionability to finance leases, both consumer and commercial. [Citation] authorizes the trial court to find "any clause of a lease contract to have been unconscionable at the time it was made * * *." If it so finds, the court is given the power to "refuse to enforce the lease contract, * * * enforce the remainder of the lease contract without the unconscionable clause, or * * * limit the application of the unconscionable clause as to avoid any unconscionable result." [Citation]

In this case, the trial court made no findings as to whether the finance lease was unconscionable. The primary purpose of the doctrine of unconscionability is to prevent oppression and unfair surprise. [Citation] "Oppression" refers to substantive unconscionability and arises from overly burdensome or punitive terms of a contract, whereas "unfair surprise" refers to procedural unconscionability and is implicated in the formation of a contract, when one of the parties is either overborne by a lack of equal bargaining power or otherwise unfairly or unjustly drawn into a contract. [Citation]

It should be pointed that, although harsh, many characteristics of a finance lease are not inherently unconscionable and, as we have discussed, are specifically authorized by statute. Simply because a finance lease has a "hell or high water clause" does not make it unconscionable. As noted, a finance lease is a separate animal—it is supposed to secure minimal risk to the lessor. At least one court has rejected the argument that an acceleration clause in a commercial finance lease is punitive and unconscionable in the context of parties of relatively equal bargaining power. See [Citation]

At the heart of Arora's defense in this case was his claim that he was misled into signing the finance lease by the CCC representative and was unfairly surprised to find himself the unwitting signatory of an oppressive lease. This is clearly an argument that implicated procedural unconscionability. His claim of being an unwitting signatory, however, must be carefully balanced against the law in Ohio that places upon a person a duty to read any contract before signing it, a duty that is not excused simply because a person willingly gives into the encouragement to "just go ahead and sign." See [Citation]

Moreover, we note that courts have also recognized that the lessor may give, through word or conduct, the lessee consent to cancel an otherwise noncancelable lease. [UCC 2A-407(2)(b)] makes a finance lease "not subject to cancellation, termination, modification, repudiation, excuse, or substitution *without the consent of the party to whom it runs*." (Emphasis supplied.) As noted by the court in *Colonial Court* [Citation], the UCC does not say anything with respect to the form or content of the consent. The *Colonial Pacific* court concluded, therefore, "that the consent may be oral and may be established by conduct that reasonably manifests an intent. * * * Any manifestations that the obligation of the lessee will not be enforced independently of the obligation that runs to the consenting party is sufficient." The question whether consent has been given to a cancellation is a question of fact for the trier of fact.

We raise this point because the evidence indicates that there was some communication between Arora and ILC before ILC retrieved the ATM. It is unclear whether ILC removed the ATM at Arora's request, or whether the company was forcibly repossessing the equipment pursuant to the default provision of the lease. In view of the murkiness of the testimony, it is unclear when the ATM was taken back and when the final lease payment was made. One interesting question that arises from ILC's retrieval of the ATM, not addressed in the record, is what ILC did with the equipment afterward. Did ILC warehouse the equipment for the next four and one-half years (conduct that would appear unprofitable and therefore unlikely) or did the company then turn around and lease the ATM to someone else? If there was another lease, was ILC actually seeking a double recovery on the ATM's rental value? In this regard, we note that the trial court ruled that ILC had failed to mitigate its damages, a finding that is not supported by the current record, but may well prove to be true upon further trial of the matter.

In sum, this is a case that requires a much more elaborate presentation of evidence by the parties, and much more detailed findings of fact and conclusions of law than those actually made by the trial court. We sustain ILC's assignment of error upon the basis that the trial court did not apply the correct legal analysis, and that the evidence of record did not mandate a judgment in Arora's favor. Because of the number of outstanding issues and unresolved factual questions, we reverse the trial court's judgment and remand this case for a new trial consistent with the law set forth in this opinion.

Judgment reversed and cause remanded.

CASE QUESTIONS

1. Why would a finance lease have such an iron-clad, “hell or high water” noncancellation clause as is apparently common and demonstrated here?
2. On what basis did the lower court rule in the defendant’s favor?
3. What is an acceleration clause?
4. What was Mr. Arora’s main defense? What concern did the court have with it?
5. The appeals court helpfully suggested several arguments the defendant might make on remand to be relieved of his contract obligations. What were they?

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16.6: Summary and Exercises

Summary

Sales law is a special type of contract law, governed by Article 2 of the Uniform Commercial Code (UCC), adopted in every state but Louisiana. Article 2 governs the sale of goods only, defined as things movable at the time of identification to the contract for sale. Article 2A, a more recent offering, deals with the leasing of goods, including finance leases and consumer leases. The Convention on Contracts for the International Sale of Goods (CISG) is an international equivalent of Article 2.

Difficult questions sometimes arise when the subject of the contract is a hybrid of goods and real estate or goods and services. If the seller is called on to sever crops, timber, or minerals from the land, or the buyer is required to sever and can do so without material harm to the land, then the items are goods subject to Article 2. When the goods are "sold" incidental to a service, the "predominant factor" test is used, but with inconsistent results. For two categories of goods, legislation specifically answers the question: foodstuffs served by a restaurant are goods; blood supplied for transfusions is not.

Although they are kin, in some areas Article 2 differs from the common law. As regards mutual assent, the UCC abolishes the mirror image rule; it allows for more indefiniteness and open terms. The UCC does away with some requirements for consideration. It sometimes imposes special obligations on merchants (though defining a merchant is problematic), those who deal in goods of the kind, or who by their occupations hold themselves out as experts in the use of the goods as between other merchants and in selling to nonmerchants. Article 2 gives courts greater leeway than under the common law to modify contracts at the request of a party, if a clause is found to have been unconscionable at the time made.

EXERCISES

1. Ben owns fifty acres of timberland. He enters into a contract with Bunyan under which Bunyan is to cut and remove the timber from Ben's land. Bunyan enters into a contract to sell the logs to Log Cabin, Inc., a homebuilder. Are these two contracts governed by the UCC? Why?
2. Clarence agreed to sell his farm to Jud in exchange for five antique cars owned by Jud. Is this contract governed by the UCC? Why?
3. Professor Byte enters into a contract to purchase a laptop computer from Ultra-Intelligence Inc. He also enters into a contract with a graduate student, who is to write programs that will be run on the computer. Are these two contracts governed by the UCC? Why?
4. Pat had a skin problem and went to Dr. Pore, a dermatologist, for treatment. Dr. Pore applied a salve obtained from a pharmaceutical supplier, which made the problem worse. Is Dr. Pore liable under Article 2 of the UCC? Why?
5. Zanae visited the Bonita Burrito restaurant and became seriously ill after eating tainted food. She was rushed to a local hospital, where she was given a blood transfusion. Zanae developed hepatitis as a result of the transfusion. When she sued the restaurant and the hospital, claiming remedies under the UCC, both defended the suit by arguing that they were providing services, not goods. Are they correct? Why?
6. Bill, the owner of Bill's Used Books, decided to go out of business. He sold two of his bookcases to Ned. Ned later discovered that the bookcases were defective and sued Bill on the theory that, as a merchant, he warranted that the bookcases were of fair, average quality. Will Ned prevail on this theory? Why?
7. Rufus visited a supermarket to purchase groceries. As he moved past a display of soda pop and perhaps lightly brushed it, a bottle exploded. Rufus sustained injury and sued the supermarket, claiming breach of warranty under the UCC. Will Rufus win? Why?
8. Carpet Mart bought carpet from Collins & Aikman (Defendant) represented to be 100 percent polyester fiber. When Carpet Mart discovered in fact the carpet purchased was composed of cheaper, inferior fiber, it sued for compensatory and punitive damages. Defendant moved for a stay pending arbitration, pointing to the language of its acceptance form: "The acceptance of your order is subject to all the terms and conditions on the face and reverse side hereof, including arbitration, all of which are accepted by buyer; it supersedes buyer's order form."

   The small print on the reverse side of the form provided, among other things, that all claims arising out of the contract would be submitted to arbitration in New York City. The lower court held that Carpet Mart was not bound by the arbitration agreement appearing on the back of Collins & Aikman's acknowledgment form, and Defendant appealed. How should the appeals court rule?

9. Plaintiff shipped to Defendant—Pizza Pride Inc. of Jamestown, North Carolina—an order of mozzarella cheese totaling $11,000. That same day, Plaintiff mailed Defendant an invoice for the order, based on Plaintiff's understanding that an oral contract existed between the parties whereby Defendant had agreed to pay for the cheese. Defendant was engaged in the real estate business at this time and had earlier been approached by Pizza Pride Inc. to discuss that company's real estate investment potential. Defendant denied ever guaranteeing payment for the cheese and raised the UCC's Statute of Frauds, Section 2-201, as an affirmative defense. The Plaintiff contended that because Defendant was in the business of buying and selling real estate, she possessed knowledge or skill peculiar to the practices involved in the transaction here. After hearing the evidence, the court concluded as a matter of law that Defendant did agree to pay for the cheese and was liable to Plaintiff in the amount of $11,000. Defendant appealed. How should the appeals court rule?
10. Seller offered to sell to Buyer goods at an agreed price "to be shipped to Buyer by UPS." Buyer accepted on a form that included this term: "goods to be shipped FedEx, Buyer to pay freight." Seller then determined not to carry on with the contract as the price of the goods had increased, and Seller asserted that because the acceptance was different from the offer, there was no contract. Is this correct?

SELF-TEST QUESTIONS

1. Among subjects the UCC does not cover are
    1. letters of credit
    2. service contracts
    3. sale of goods
    4. bank collections
2. When a contract is unconscionable, a court may
    1. refuse to enforce the contract
    2. strike the unconscionable clause
    3. limit the application of the unconscionable clause
    4. take any of the above approaches
3. Under the UCC, the definition of *merchant* is limited to
    1. manufacturers
    2. retailers
    3. wholesalers
    4. none of the above
4. For the purpose of sales law, *goods*
    1. always include items sold incidental to a service
    2. include things movable at the time of identification to the contract
    3. include blood supplied for transfusions
    4. include all of the above
5. Article 2 differs from the common law of contracts
    1. in no substantial way
    2. by disallowing parties to create agreements with open terms
    3. by obligating courts to respect all terms of the contract
    4. by imposing special obligations on merchants

SELF-TEST AnswerS

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

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17: TITLE AND RISK OF LOSS

Learning Objectives

After reading this chapter, you should understand the following:

1. Why title is important and at what point in the contracting relationship the buyer acquires title
2. Why risk of loss is important, when risk of loss passes to the buyer, and when the buyer acquires an insurable interest
3. Under what circumstances the buyer can obtain title when a nonowner sells the goods

Parties to a sales contract will usually agree on the obvious details of a sales transaction—the nature of goods, the price, and the delivery time, as discussed in the next chapter. But there are two other issues of importance lurking in the background of every sale:

1. When does the title pass to the buyer? This question arises more in cases involving third parties, such as creditors and tax collectors. For instance, a creditor of the seller will not be allowed to take possession of goods in the seller's warehouse if the title has already passed to the buyer.
2. If goods are damaged or destroyed, who must bear the loss? The answer has obvious financial significance to both parties. If the seller must bear the loss, then in most cases he must pay damages or send the buyer another shipment of goods. A buyer who bears the loss must pay for the goods even though they are unusable. In the absence of a prior agreement, loss can trigger litigation between the parties.

17.1: Transfer of Title

17.2: Title from Nonowners

17.3: Risk of Loss

17.4: Cases

17.5: Summary and Exercises

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17.1: Transfer of Title

LEARNING OBJECTIVES

1. Understand why it is important to know who has title in a sales transaction.

2. Be able to explain when title shifts.

3. Understand when a person who has no title can nevertheless pass good title on to a buyer.

Scenario Introduction

Imagine this: **FreshMart Grocers** orders 500 cases of oranges from **Valencia Farms**, a supplier in Florida. The contract says nothing about when title to the oranges passes. A week later, before the oranges arrive, two issues arise:

- Creditors of Valencia Farms attempt to seize the shipment, claiming Valencia still owns it.
- A truck accident damages part of the load—FreshMart wants to know whether it or Valencia must bear the loss.
- FreshMart also tries to add the oranges to its business insurance policy, but the insurer asks, *"Do you have title yet?"*

This scenario illustrates why knowing exactly when title shifts is critical in sales law.

Why It Is Important When Title Shifts

It Affects Whether a Sale Has Occurred

A sale cannot occur without a shift in title. The Uniform Commercial Code (UCC) defines a sale as a "transfer of title from seller to buyer for a price." Without a title shift, there is no sale, and key protections—such as the implied warranty of merchantability—may not apply.

- In the FreshMart example, if title has not passed yet, there might not be a "sale," which affects whether FreshMart can claim warranty protections.

Creditors' Rights

Creditors can only seize goods if the debtor has title. If Valencia still holds title to the oranges, creditors could seize them. If title has shifted to FreshMart, creditors would be wrongfully taking FreshMart's property—a tort called conversion.

- Applied to the scenario: the creditors' rights hinge entirely on whether title passed before the oranges left Valencia's facility.

Insurable Interest

A buyer cannot legally insure goods without having an insurable interest. Title often determines this. Without it, an insurance policy could be treated as an illegal wager.

- In FreshMart's case, whether it can add the oranges to its insurance policy depends on when title shifted from Valencia.

Goods Identified to the Contract

The Identification Requirement

UCC § 2-401 provides that title cannot pass until the goods are identified to the contract—meaning the seller has designated specific goods for delivery.

- Applied to FreshMart: title cannot pass until Valencia selects and sets aside the 500 cases of oranges for FreshMart's order.

The CISG echoes this principle: Article 67 states that risk does not pass until goods are clearly identified by markings, shipping documents, or notice to the buyer.

When Are Goods Identified?

- **By Agreement** – The parties may agree on when identification occurs (UCC § 2-501(1)).
- **Default Rules** (UCC § 2-501(1)):
  - Existing, identified goods: identification occurs at the time of contracting.
  - Future goods: identification occurs when the seller marks, ships, or otherwise designates them.
  - Crops or unborn animals: identification occurs when planted, conceived, or otherwise committed to the contract.

Example: If a buyer says, "I'll take that sponge on the shelf," identification occurs immediately. But if the buyer says, "I'll take a gross of these sponges," identification occurs only when the seller selects the specific cartons.

- For FreshMart: identification happens once Valencia marks or ships *those* cases of oranges.

When Title Shifts

By Agreement

The parties may explicitly agree when title passes (UCC § 2-401(1)). Many contracts specify this in writing.

- If FreshMart's contract stated, "Title and risk of loss pass upon loading in Florida," then FreshMart owned the oranges as soon as Valencia placed them on the truck.

By Delivery Terms

If no express agreement exists, delivery terms usually determine when title passes.

- **Shipment Contracts (UCC §§ 2-319, 2-504)**:
  - **F.O.B. [place of shipment]**: Title passes when goods are delivered to the carrier.
  - **F.A.S. [port]**: Title passes when goods are placed alongside the ship.
  - **C.I.F. / C.&F.**: Title passes when goods are shipped, though the price includes cost, insurance, and freight.

  Example: If Delta Sponge Makers ships goods "F.O.B. Seattle," title passes once the carrier takes possession in Seattle.

  Scenario tie-in: If FreshMart's contract with Valencia says "F.O.B. Florida," title passed the moment the oranges were loaded on the truck. FreshMart, not Valencia, bears the risk from that point forward.

- **Destination Contracts (UCC §§ 2-319, 2-322, 2-324)**:
  - **F.O.B. [destination]**: Title passes when goods are tendered at the buyer's location.
  - **Ex-ship**: Title passes when goods are unloaded from the ship.
  - **No arrival, no sale**: Title passes only if goods arrive; if not, the buyer has no obligation.

  Example: If Delta delivers sponges to Very Fast Foods' warehouse under an F.O.B. destination term, title passes when the truck arrives and tender is made.

Scenario tie-in: If FreshMart's contract instead says "F.O.B. FreshMart warehouse," Valencia bears the risk of the accident on the highway until delivery is completed.

- **Goods Not to Be Moved (UCC § 2-401(3))**:
  - With documents of title: Title passes when documents (e.g., warehouse receipts, bills of lading) are delivered.
  - Without documents: Title passes at the time and place of contracting.

  Example: If Delta sells sponges stored in a warehouse and delivers a warehouse receipt, title passes when the receipt is handed over. If no documents are involved, title passes when the contract is signed.

UCC Default Provision

If the parties say nothing about title or delivery, UCC § 2-401(2) provides that title passes when the seller completes delivery obligations.

- For FreshMart: if the contract said nothing about F.O.B. terms, courts would ask, *What was Valencia's obligation?* If it was to load the truck, title shifted at loading. If it was to deliver to FreshMart, title shifted at delivery.

KEY TAKEAWAY

Title is important for three reasons: it determines whether a sale has occurred, it determines rights of creditors, and it affects who has an insurable interest. Title may shift by explicit agreement, by delivery terms, or under UCC default rules. In the FreshMart/Valencia scenario, the answers to who owns the oranges, who bears the loss of the accident, and whether creditors or insurers must recognize FreshMart's rights all depend on when title legally passed.

EXERCISES

1. Why does it matter who has title?
2. If the parties do not otherwise agree, when does title shift from seller to buyer?
3. Why does the question of delivery terms arise in examining when title shifts?
4. When does title shift for goods stored in a warehouse that are not to be moved?

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17.2: Title from Nonowners

LEARNING OBJECTIVE

1. Understand when and why a nonowner can nevertheless pass title on to a purchaser.

The Problem of Title from Nonowners

Up to this point, our discussion has assumed that the seller has **good title** to the goods and can therefore pass it to the buyer. But what happens when the seller does **not** have good title—or has only a **voidable title**?

This problem arises when someone who is not the true owner (a **nonowner**) is in possession of goods and then sells them to an innocent purchaser. The question becomes: **what title, if any, does the purchaser acquire?**

The "Eternal Triangle"

Courts often describe this problem as an **eternal triangle** involving three parties and three steps:

1. **The true owner** entrusts or loses possession of the goods, or the goods are wrongfully taken (e.g., through theft, fraud, or loan).
2. **The nonowner**—who now has possession but no rightful ownership—sells the goods to an **innocent purchaser** who pays value.
3. The **nonowner** disappears, goes bankrupt, or is otherwise unavailable, leaving the true owner and the innocent purchaser in conflict over who gets the goods.

The result is a legal battle between two innocent parties:

- The **true owner**, who claims the goods were wrongfully taken and demands their return, often bringing an action for **conversion** (the wrongful exercise of ownership over another's property).
- The **purchaser**, who insists that they bought the goods honestly and for value, and should not lose both the goods and the money paid.

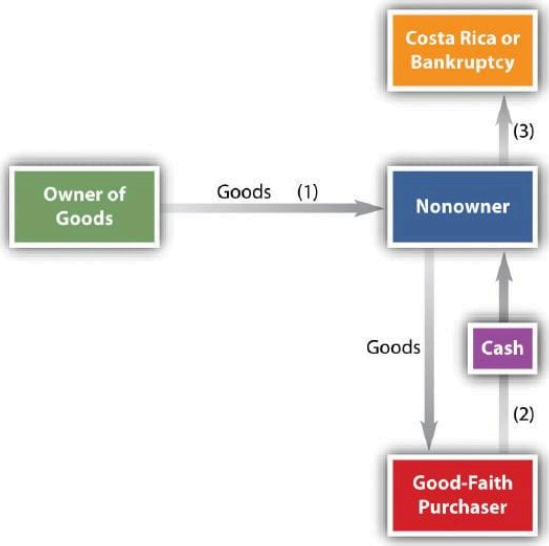
The Core Issue

The law must decide: **Who bears the loss— the original owner or the innocent purchaser?**

- If the law favors the **true owner**, then the purchaser loses both the money paid and the goods.
- If the law favors the **purchaser**, then the original owner loses the goods but must look to the wrongdoer (often absent, bankrupt, or judgment-proof) for recovery.

This tension highlights one of the most challenging problems in sales law: balancing the rights of true owners with the need to protect innocent purchasers and promote confidence in commercial transactions.

Figure 18.1 Sales by Nonowners



The Response to the Problem of Title from Nonowners

The Basic Rule

A fundamental principle of sales law is that **a person cannot transfer better title than he or she has**. The Uniform Commercial Code (UCC) recognizes this principle in Sections 2-403, 2A-304, and 2A-305.

This means that if someone without valid title purports to sell goods, the buyer generally acquires no title. For instance, if a thief steals a car and then sells it to an innocent purchaser, the true owner is entitled to recover the car (or its value). Because the thief had no title, he could not pass any title to the buyer.

Courts emphasize that people are not required to retain physical possession of their goods to retain ownership—after all, cars must be left with mechanics for repair and clothes left with dry cleaners. If thieves could pass good title, stolen goods would flood the marketplace, undermining confidence in commerce. Accordingly, owners may recover their property from any downstream purchaser through an action for **replevin** (an action to recover goods wrongfully taken).

At the same time, commerce requires protecting buyers who purchase in good faith from reputable sellers. If good-faith buyers could never rely on the title of those they purchase from, the marketplace would become unworkable. Thus, the UCC creates several **exceptions** to the basic rule, recognizing circumstances in which an innocent purchaser may acquire better title than the seller had.

The Exceptions

As noted, there are exceptions to the law governing the sale of goods.

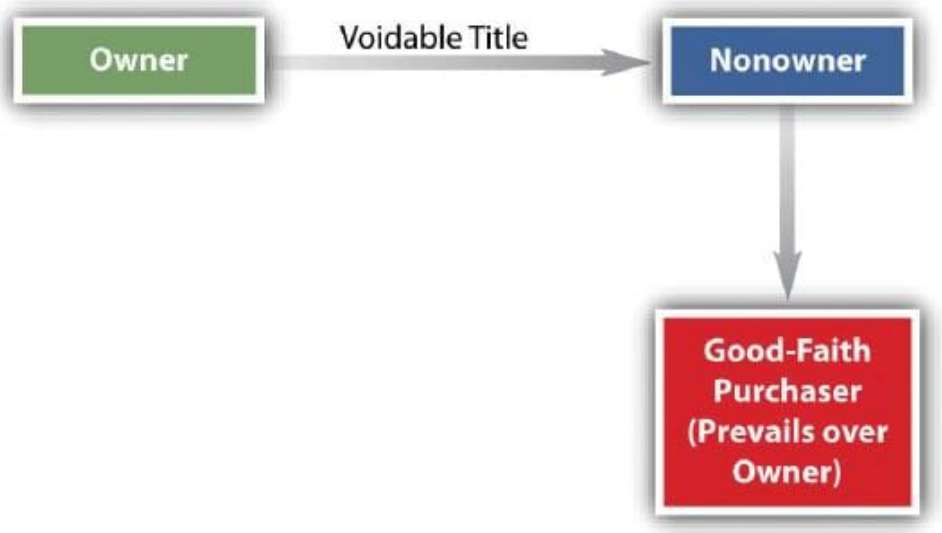
Sellers with a Voidable Title

The UCC provides that a person holding **voidable title** has the power to transfer good title to a **good-faith purchaser for value** (UCC §§ 2-403(1), 2A-304, 2A-305).

- **Good faith** means honesty in fact in the transaction.
- **Purchaser** includes anyone acquiring an interest in property—not only through cash payment, but also through mortgage, lien, pledge, or even gift.
- **Value** includes any legally sufficient consideration, such as a binding promise to extend credit or settle a preexisting claim.

Example 1 (Minor Seller):
Rita, age sixteen, sells her video game to Annie. Because Rita is a minor, she has the power to rescind the contract, making Annie's title voidable. If Annie resells the game to Donald, who buys it in good faith, Donald acquires good title. If Rita later attempts to rescind, it is too late: the voidable title has ripened into good title in Donald's hands.

Figure 18.2 Voidable Title



Example 2 (Bounced Check):
Suppose Rita is an adult and Annie pays with a check that later bounces. Before the check clears, Annie sells the game to Donald, who purchases in good faith. Donald still acquires good title, even though Annie's title was voidable.

The UCC also protects good-faith purchasers in other scenarios, such as:

1. Where the seller was deceived about the buyer's identity.
2. Where payment was supposed to be in cash but never received.
3. Where delivery was induced by fraud punishable as larceny.

Case Illustration:
In *Dimension Funding, L.L.C. v. D.K. Associates, Inc.* (Wash. Ct. App. 2008), a business fraudulently sold a leased Volkswagen to an innocent purchaser, Edward Seabold. Although the lessor, Dimension, never authorized the sale, the court held that Seabold kept the car. Because Dimension voluntarily entrusted the car to the lessee (who then abused that authority), the innocent purchaser's rights prevailed.

Entrustment

Another exception arises under the **entrustment doctrine** (UCC §§ 2-403(2), 2A-304(2), 2A-305(2)).

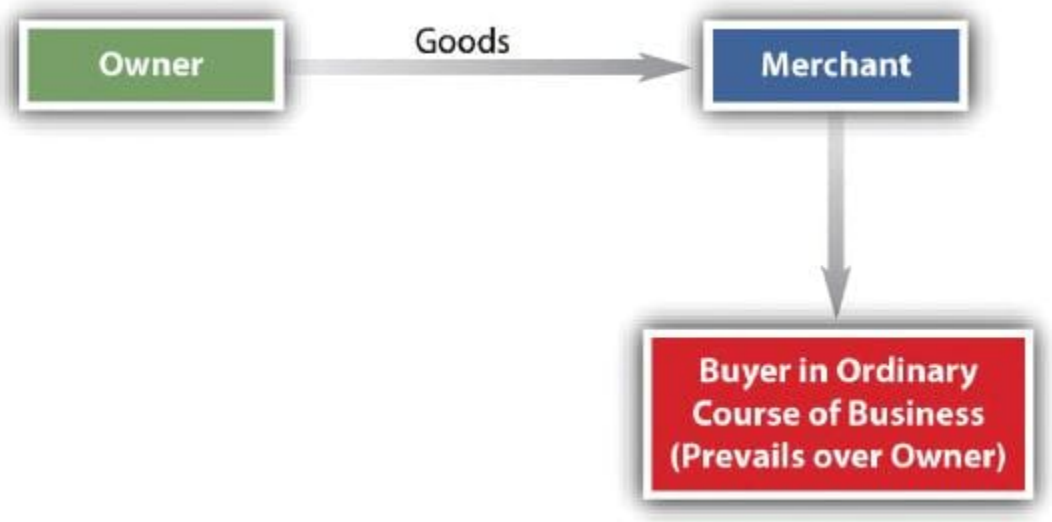
If an owner entrusts goods to a merchant who deals in goods of that kind, the merchant has the power to transfer all rights of the entrustor to a **buyer in the ordinary course of business**—even if the sale violates the entrustor's instructions.

- A **buyer in the ordinary course** is one who buys goods in good faith, without knowledge of another's ownership rights, and in the normal flow of the seller's business.

Example (Jewelry Entrustment):
Bess entrusts her family pearl necklace to Wellborn's Jewelers for cleaning. By mistake, Wellborn sells the necklace to Clara, a buyer in the ordinary course. Under the UCC, Clara gets good title—even though Wellborn had no right to sell it. Bess's remedy is against Wellborn for conversion, not against Clara.

By contrast, if Bess's cleaning woman (with no authority) took the necklace to Wellborn's and Wellborn sold it, Clara would not acquire good title. Because the cleaning woman had no title to transfer, the entrustment doctrine would not apply.

Figure 18.3 Entrustment



Entrustment is based on estoppel: when an owner clothes another with the appearance of authority to sell goods, the owner may be barred from reclaiming them from a good-faith purchaser. As one court explained:

> "A rightful owner may be estopped by his own acts from asserting his title. If he has invested another with the usual evidence of title, or an apparent authority to dispose of it, he will not be allowed to make claim against an innocent purchaser dealing on the faith of such apparent ownership."
> —*Zendman v. Harry Winston, Inc.* (N.Y. 1953).

KEY TAKEAWAY

The general rule—for obvious reasons—is that nobody can pass on better title to goods than he or she has: a thief cannot pass on good title to stolen goods to anybody. But in balancing that policy against the reasonable expectations of good-faith buyers that they will get title, the UCC has made some exceptions. A person with voidable title can pass on good title to a good-faith purchaser, and a merchant who has been entrusted with goods can pass on title of the entrustor to a good-faith purchaser.

EXERCISES

1. Why is it the universal rule that good title to goods cannot be had from a thief?
2. What is the "voidable title" exception to the universal rule? Why is the exception made?
3. What is the "entrusting" exception to the general rule?

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17.3: Risk of Loss

LEARNING OBJECTIVES

1. Understand why who has the risk of loss is important.
2. Know how parties may agree on when the risk of loss shifts.
3. Know when the risk of loss shifts if there is no breach, and if there is a breach.
4. Recognize what "insurable interest" is, why it is important, and how it attaches.

Why Risk of Loss Is Important

"Risk of loss" refers to who bears the financial responsibility if goods are lost or destroyed through no fault of either party. This is a crucial issue in sales contracts. Suppose Buyer contracts to purchase a new car for $35,000. While the car is in transit, a landslide destroys it. Who absorbs the loss—Buyer or Seller?

Under the **CISG, Article 66**, "[l]oss of or damage to the goods after the risk has passed to the buyer does not discharge him from his obligation to pay the price, unless the loss or damage is due to an act or omission of the seller." In other words, once the risk passes, the buyer must pay, even if the goods are destroyed—unless the seller caused the problem.

When Risk of Loss Passes

Parties May Agree

Just as parties may decide when title passes, they may also agree on who bears the risk of loss and even devise formulas to divide it (UCC § 2-303). Delivery terms such as F.O.B., F.A.S., or ex-ship, already discussed earlier, often serve this function.

Risk of loss also arises in **trial sales**:

- **Sale on Approval** – Goods are delivered for the buyer's trial use. Title and risk remain with the seller until the buyer accepts. For example, Delta sends Very Fast Foods a box of 100 sponges "on approval." Before Very Fast decides, a fire destroys the sponges. Delta, not Very Fast, bears the loss (UCC § 2-327(1)(a)).
- **Sale or Return** – Goods are delivered for resale, with the buyer retaining the right to return them if they don't sell. Title and risk pass to the buyer immediately. A clothing shop that takes new spring fashions "on return" bears the loss if unsold clothes are destroyed before being returned.

Creditors' Rights: In a **sale on approval**, creditors of the buyer cannot claim the goods, since title has not shifted. In a **sale or return**, creditors may seize the goods while in the buyer's possession, because title rests with the buyer (UCC § 2-326).

- **Consignment Sales** – A consignee sells goods on behalf of the consignor, typically for a commission. The UCC treats consignments like sales or return contracts, meaning the consignee is deemed the buyer, bearing the risk of loss and subject to creditor claims—unless statutory protections (such as notice filings under Article 9) are followed (UCC § 2-326(3)).

UCC Default Rules

If the parties fail to allocate risk of loss, the UCC supplies rules. A general principle is that **risk passes when the seller has completed obligations under the contract**. Importantly, this is not always the same as when **title** passes.

1. Shipment Contracts

If the seller is required only to ship goods (not deliver them to a destination), risk passes to the buyer when goods are delivered to the first carrier (UCC § 2-509(1)(a)).

- **Example:** Delta ships sponges by truck to Very Fast Foods. Once the carrier takes possession, risk passes to Very Fast—even before delivery.

The CISG adopts the same rule in **Article 67**.

2. Destination Contracts

If the seller must deliver goods to a specific place, risk passes when the goods are tendered at that location (UCC § 2-509(1)(b)).

- **Example:** If Delta must deliver sponges to Very Fast's warehouse, risk passes only when the sponges arrive and are tendered.

CISG **Article 69** mirrors this: risk passes when the buyer takes over the goods or fails to do so when tendered.

3. Goods Not to Be Moved

If goods are already in storage:

- Risk passes when the buyer receives a **negotiable document of title** (e.g., warehouse receipt).
- Or when the bailee (e.g., warehouse) acknowledges the buyer's right to possession.
- Or, with a **nonnegotiable document of title**, when the buyer has had reasonable time to present it (UCC § 2-509(2)).

4. All Other Cases

If none of the above applies, risk of loss passes when the buyer actually receives the goods (UCC § 2-509(3)).

Case Example: In *Ramos* (Section 18.4.3), a customer paid for merchandise but never received it due to a mishap. Because the seller was a merchant, risk of loss did not shift until the buyer actually received the goods.

Risk of Loss Where Breach Occurs

The rules differ if either party breaches:

1. **Seller Breach** – If goods are nonconforming and rejected, the risk stays with the seller until cure or acceptance (UCC § 2-510(1)).
   - Example: Delta tenders defective sponges, which Very Fast rejects. Before cure, the goods are destroyed. Delta bears the loss.
   - Wrinkle: If the buyer accepted goods before discovering the nonconformity, risk of loss is on the seller only to the extent of any deficiency in the buyer's insurance coverage (UCC § 2-510(2)).
2. **Buyer Breach** – If the buyer wrongfully repudiates or refuses goods after they are identified to the contract, the risk of loss shifts to the buyer for a "commercially reasonable time" (UCC § 2-510(3)).
   - Example: Very Fast repudiates its sponge contract before delivery. A warehouse fire destroys the goods. Even though delivery never occurred, Very Fast may bear the loss to the extent the seller's insurance doesn't cover it.

Insurable Interest

Why It Matters

Insurable interest determines who can obtain insurance coverage on goods. Without an insurable interest, insurance contracts would amount to wagers and be unenforceable. Disputes often arise between insurers over whether the buyer or seller had an insurable interest at the time of loss.

Buyer's Insurable Interest

The buyer obtains a **special property interest** and thus an insurable interest when goods are identified to the contract—even

before title passes (UCC § 2-501(1)). Identification can occur by branding, tagging, or segregating goods, or through the UCC's default rules.

- **Example:** Very Fast orders a specific lot of sponges, which Delta tags and sets aside. Even before delivery, Very Fast has an insurable interest.

Seller's Insurable Interest

The seller retains an insurable interest as long as he holds title or any security interest in the goods.

Other Buyer Rights

The buyer's special property interest confers rights beyond insurance:

- If the buyer prepays and the seller becomes insolvent within 10 days, the buyer may recover the goods (UCC § 2-502).
- The buyer may sue a third party that damages goods identified to the contract, even before delivery.

KEY TAKEAWAY

Knowing who has the risk of loss in a contract for the sale of goods is important for obvious reasons: it is not uncommon for goods to be lost or stolen between the time they leave the seller's possession and before the buyer gets them. The parties are certainly free to agree on when the risk of loss shifts; if they do not, the UCC says it shifts when the seller has completed obligations under the contract. Thus if there is no breach, the risk of loss shifts upon delivery. If there is a breach, the UCC places the risk of loss on the breaching party, with this caveat: where the nonbreaching party is in control of the goods, the UCC places the risk of loss on that party to the extent of her insurance coverage. So if there is a breach by the seller (delivery of nonconforming goods), the risk of loss never shifts except if the buyer has taken possession of the nonconforming goods; in that case, the buyer does have the risk of loss insofar as her insurance covers the loss. If the buyer breaches by repudiating before the risk of loss passes to him (by the goods' delivery), the UCC permits the seller to treat the risk of loss as resting on the buyer for a commercially reasonable time as to goods identified to the contract.

Insurable interest becomes important when goods suffer a casualty loss because—among other reasons—often neither the seller's nor the buyer's insurance company wants *its* insured to have an interest in the goods: each side denies it. The seller retains an insurable interest if he has title to or any security interest in the goods, and the buyer obtains an insurable interest by identification of existing goods as goods to which the contract refers. A person has an insurable interest in any property owned or in the person's possession.

EXERCISES

1. Which is more important in determining who has the risk of loss, the agreement of the parties or the UCC's default provisions?
2. When does the risk of loss shift to the buyer if the parties have no agreement on the issue?
3. Why does the UCC impose the risk of loss to the extent of his insurance on a nonbreaching party if that party has control of the goods?
4. Why can a person not take out insurance for goods in which the person has no interest? How does a seller retain an insurable interest? When does the buyer get an insurable interest?

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17.4: Cases

Transfer of Title: Destination Contracts

Sam and Mac, Inc. v. Treat

783 N.E.2d 760 (Ind. App. 2003)

Anthony L. Gruda and Sharon R. Gruda (the "Grudas") owned and operated Gruda Enterprises, Inc. (Gruda Enterprises), which in turn operated The Kitchen Works, a kitchen supply business. On March 5, 1998, Gruda Enterprises contracted to sell a set of kitchen cabinets to Sam and Mac, Inc. [SMI], a commercial construction and contracting corporation. Gruda Enterprises was also to deliver and install the cabinets. Because it did not have the cabinets in stock, Gruda Enterprises ordered them from a manufacturer. On March 14, 1998, nine days after placing the order, SMI pre-paid Gruda Enterprises for the cabinet order.

On May 14, 1998, prior to delivery and installation of the cabinets, the Grudas ceased operation of Gruda Enterprises and filed for personal bankruptcy. Gruda Enterprises did not file for bankruptcy and was not dissolved. Instead, the Grudas' stock in Gruda Enterprises became part of their bankruptcy estate....When no cabinets were delivered or installed, and the Grudas ceased operation of Gruda Enterprises, SMI asked Treat, who was the landlord of Gruda Enterprises, to open the business premises and permit SMI to remove cabinets from the property. Treat declined, stating that he feared he would incur liability to Gruda Enterprises if he started giving away its inventory. Treat and other secured creditors sued Gruda Enterprises, which owed them money. [Summary judgment was for Treat, SMI appeals.]

SMI contends that there was a completed sale between SMI, as the buyer, and Gruda Enterprises, as the seller. Specifically, SMI maintains that title to the cabinets under [UCC] 2-401(3)(b) passed to SMI when the contract for sale was [made]....Therefore, SMI argues that the trial court improperly granted summary judgment in favor of Treat because [SMI] held title and, thus, a possessory interest in the cabinets....

[T]he contract is governed by the...Indiana Uniform Commercial Code (UCC). 2-401 establishes the point in time at which title passes from seller to buyer. Specifically, 2-401(2) provides, in pertinent part, that unless explicitly agreed, title passes to the buyer at the time and place at which the seller completes his performance with respect to the physical delivery of goods....

Moreover, the record indicates that SMI and Gruda Enterprises did not have an explicit agreement to pass title at any other time, or at any time prior to actual delivery of the cabinets. SMI argues that title passed to it under 2-401(3)(b) ["where delivery is to be made without moving the goods,...if the goods are at the time of contacting already identified and no documents are to be delivered, title passes at the time and place of contacting."]....However, the record reflects that SMI admitted that the terms of the contract required Gruda Enterprises to not only order the cabinets, but to deliver and install them at the location specified by SMI, i.e. the house that SMI was building. 2-403(3) applies to purchases of goods where delivery is to be made without moving the goods. SMI argues that since the cabinets were identified at the time of contracting and no documents needed delivery, title passed at the time and place of contracting....

[T]itle to goods cannot pass under a contract for sale prior to their identification in the contract. *See* 2-401(1). This does not mean that title passes when the goods are identified. It only means that identification is merely the earliest possible opportunity for title to pass....[I]dentification does not, in and of itself, confer either ownership or possessory rights in the goods. [UCC] 2-401(2)(b) states that "[i]f the contract requires delivery at destination, title passes on tender there." In the present case, tender did not occur when Gruda Enterprises called SMI to notify it that the cabinets were in and ready to be delivered and installed. SMI requested that the cabinets remain at the warehouse until the house it was building was ready for the cabinets to be installed....[W]e find that SMI and Gruda Enterprises agreed to a destination point, *i.e.* the house that SMI was building. Accordingly, we find that 2-401(2)(b) is also applicable. The title to the cabinets did not pass to SMI because the cabinets were not delivered and installed at the agreed upon destination. Therefore, we conclude that SMI does not have a possessory interest in the cabinets.

Based on the foregoing, we conclude that the trial court properly granted summary judgment in favor of Treat....Affirmed.

CASE QUESTIONS

1. One argument made by the plaintiff was that because the plaintiff had paid for the goods and they had been identified to the contract, title passed to the plaintiff. Why did the court disagree with this contention?
2. When would title to the cabinets have shifted to the plaintiff?
3. This is footnote 2 (it was not included in the parts of the case set out above): "We note that Treat owned Kitchen Wholesalers, Inc., from approximately 1987 to approximately June 20, 1996. On or about June 20, 1996, Kitchen Wholesalers, Inc. sold its assets, inventory, equipment, and business to Gruda Enterprises. The Grudas executed an Agreement for Sale of Assets, Lease, and Security Agreement, as well as a Promissory Note in which they agreed to pay $45,000 for the assets, inventory, equipment, and business, and to pay monthly rent of $1,500 for the premises where the business was located, and secured their obligations with inventory, equipment, and proceeds therefrom, of the business which they were purchasing. Treat filed and perfected a security interest in the accounts receivable, inventory, and equipment of The Kitchen Works on August 28, 1998. The Grudas currently owe Treat $61,794.99."

   This means that when the Grudas failed to pay Treat, he had a right to repossess all assets *belonging to them*, including the cabinets—Treat was a creditor of the Grudas. SMI, of course, contended it had title to the cabinets. Based on the court's analysis, who is going to get the cabinets?

Defrauding Buyer Sells to Good-Faith Purchaser for Value

Marlow v. Conley

787 N.E.2d 490, (Ind. App. 2003)

Donald E. Marlow appeals the trial court's judgment in favor of Robert L. Medley and Linda L. Medley (collectively, the "Medleys") on Marlow's complaint for replevin. Marlow raises [this issue],...whether the Medleys obtained good title to a truck pursuant to Indiana UCC 2-403(1). We affirm.

The relevant facts follow. On May 21, 2000, Robert Medley attended a car show in Indianapolis. Henderson Conley attended the same car show and was trying to sell a 1932 Ford Truck ("Truck"). Conley told Robert that he operated a "buy here, pay here car lot," and Robert saw that the Truck had a dealer license plate. Robert purchased the Truck for $7,500.00 as a gift for Linda. Conley gave Robert the Truck's certificate of title, which listed the owner as Donald Marlow. When Robert questioned Conley about the owner of the Truck, Conley responded that Marlow had signed the title as part of a deal Conley had made with him. After purchasing the Truck, Robert applied to the Bureau of Motor Vehicles for a certificate of title in Linda's name.

On December 18, 2000, Marlow filed a complaint against Conley and the Medleys....At the bench trial, Marlow testified that he had met Conley at a car show in Indianapolis on May 19, 2000, and Conley had told him that Conley owed a "car lot" on the west side of Indianapolis. Marlow also testified that Conley came to his house that night, but he "didn't let him in." Rather, Marlow testified that Conley "[came] over [his] fence...a big high fence." According to Marlow, Conley asked him to invest in Conley's business that night. Marlow gave Conley $500.00. Marlow testified that Conley came back the next day and Marlow gave him an additional $4,000.00. Marlow then testified that Conley stole the certificate of title for the Truck from Marlow's house and stole the Truck from his garage. According to Marlow, he told Conley later in the day to bring his Truck back and Conley told him that it had caught on fire. Marlow testified that he then called the police. However, in the May 30, 2000 police report, which was admitted into evidence at trial, the police officer noted the following:

The deal was [Conley] gets $4500.00, plus an orange '32 Ford truck. In return, [Marlow] would get a '94 Ford flatbed dump truck and an '89 Ford Bronco. [Marlow] stated that he has not received the vehicles and that [Conley] keeps delaying getting the vehicles for him. [Conley] gave [Marlow] several titles of vehicles which are believed to be junk. [Conley] told [Marlow] that he has a car lot at 16th and Lafayette Road.

[The trial court determined that Marlow bought the truck from Conley, paying Conley $4500 plus a Ford flatbed truck and Ford Bronco.]

...

The issue is whether the Medleys obtained good title to the Truck pursuant to Indiana UCC 2-403(1) [voidable title passed on to good-faith purchaser]. We first note that UCC 2-401(2) provides that "[u]nless otherwise explicitly agreed, title passes to the buyer at the time and place at which the seller completes his performance with reference to the physical delivery of the

goods....” Further, 2-403(1) provides as follows: “A purchaser of goods acquires all title which his transferor had or had power to transfer....A person with voidable title has power to transfer a good title to a good faith purchaser for value. When goods have been delivered under a transaction of purchase, the purchaser has such power even though:...(d) the delivery was procured through fraud punishable as theft under the criminal law.”

Thus, Conley, as purchaser of the goods, acquired all title to the Truck that Marlow, as transferor, had or had power to transfer. Additionally, even if Conley had “voidable title,” he had the power to transfer good title to the Medleys if they were “good faith purchasers for value.” Consequently, we must determine whether Conley had voidable title and, if so, whether the Medleys were good faith purchasers for value.

A. Voidable Title

We first determine whether Conley had voidable title to the Truck....[T]he UCC does not define “voidable title.” However, we have held that Indiana’s UCC 2-403 is consistent with Indiana’s common law, which provided that “legal title passes to a defrauding buyer. This title is not void; it is voidable, which means that when title gets into the hands of a bona fide purchaser for value then he will prevail over the defrauded seller.” [Citation] Thus, a “defrauding buyer” obtains voidable title. However, a thief obtains void title. See, e.g., [Citation] holding that a renter who stole a motor home had void title, not voidable title, and could not convey good title)....

Here, Marlow argues that Conley stole the Truck and forged his name on the certificate of title. However, the trial court was presented with conflicting evidence regarding whether Conley stole the Truck and the certificate of title or whether Conley and Marlow had a business deal and Conley failed to comply with the agreement. The trial court found that:

Evidence presented concerning [Marlow’s] complaint to the Indianapolis Police Department on May 30, 2000 casts doubt on the credibility of [Marlow’s] trial testimony as the report states the truck and title were obtained by Conley in exchange for a 1994 Ford Flatbed Dump Truck and a 1989 Ford Bronco plus the payment of $4500.00 by [Marlow]. Apparently, [Marlow] was complaining to the police concerning Conley’s failure to deliver the two Ford vehicles.

...The trial court did not find Marlow’s testimony regarding the theft of the Truck and the certificate of title to be credible....[B]ased upon the trial court’s findings of fact, we must assume that the police report accurately describes the circumstances under which Conley obtained possession of the Truck and its signed certificate of title. Consequently, we assume that Marlow gave Conley $4,500.00 and the Truck in exchange for two other vehicles. Although Conley gave Marlow the certificates of title for the two vehicles, he never delivered the vehicles.

Conley’s title is voidable if “the delivery was procured through fraud punishable as theft under the criminal law” under 2-403(1)(d)....Assuming that Conley knew that he would not deliver the two vehicles to Marlow, the delivery of the Truck to Conley was procured through fraud punishable as theft. Consequently, Marlow was defrauded, and Conley obtained voidable title to the Truck....

B. Good Faith Purchasers for Value

Having determined that Conley obtained voidable title to the Truck, we must now determine whether the Medleys were good faith purchasers for value. Marlow does not dispute that the Medleys were purchasers for value. Rather, Marlow questions their “good faith” because they purchased the Truck from someone other than the person listed on the Truck’s certificate of title. [UCC 1-201919] defines good faith as “honesty in fact in the conduct or transaction concerned.” Marlow argues that Robert did not purchase the Truck in good faith because, although Robert purchased the vehicle from Conley, he was aware that the certificate of title was signed by Marlow.

...Here, the sole evidence presented by Marlow regarding the Medleys’ lack of good faith is the fact that the certificate of title provided by Conley was signed by Marlow. Robert testified that he thought Conley was a licensed dealer and operated a “buy here, pay here” car lot. The Truck had a dealer license plate. Robert questioned Conley about the certificate of title. Conley explained that Marlow had signed the title as part of a deal Conley had made with him. Robert also testified that he had previously purchased vehicles at car shows and had previously purchased a vehicle from a dealer where the certificate of title had the previous owner’s name on it....

The Medleys’ failure to demand a certificate of title complying with [the Indiana licensing statute] does not affect their status as good faith purchasers in this case....The statute does not void transactions that violate the statute. [Citations] Although the failure

to comply with [the licensing statute] may, combined with other suspicious circumstances, raise questions about a purchaser's good faith, we find no such circumstances here. Consequently, the Medleys were good faith purchasers for value....

Lastly, Marlow also argues that the Medleys violated [licensing statutes] by providing false information to the Bureau of Motor Vehicles because the Medleys allegedly listed the seller of the Truck as Marlow rather than Conley. We noted above that legal title to a vehicle is governed by the sales provisions of the UCC rather than the Indiana Certificate of Title Act. Thus, although false statements to the Bureau of Motor Vehicles under Ind.Code § 9-18-2-2 could result in prosecution for perjury, such false statements do not affect legal title to the vehicle.

In summary, we conclude that, as a defrauding buyer, Conley possessed voidable title and transferred good title to the Medleys as good faith purchasers for value....Thus, legal title to the Truck passed to the Medleys at the time Conley delivered the Truck to them. See UCC 2-401(2) ("[T]itle passes to the buyer at the time and place at which the seller completes his performance with reference to the physical delivery of the goods...."). This result is consistent with the policy behind 2-403.

Section 2-403 was intended to determine the priorities between the two innocent parties: (1) the original owner who parts with his goods through fraudulent conduct of another and (2) an innocent third party who gives value for the goods to the perpetrator of the fraud without knowledge of the fraud. By favoring the innocent third party, the Uniform Commercial Code endeavors to promote the flow of commerce by placing the burden of ascertaining and preventing fraudulent transactions on the one in the best position to prevent them, the original seller. The policy behind the UCC is to favor the Medleys because, as between the Medleys and Marlow, Marlow was in the best position to prevent the fraudulent transaction.

For the foregoing reasons, we affirm the trial court's judgment for the Medleys. Affirmed.

CASE QUESTIONS

1. The court determined Marlow was defrauded by Conley. How did Conley defraud Marlow?
2. What is the rationale, here expressed, for the UCC's provision that a defrauding purchaser (Conley) can pass on title to a good-faith purchaser for value?
3. Why did Marlow think the Medleys should not be considered good-faith purchasers?
4. Why would the UCC prevail over the state's certificate of title act?

Risk of Loss, Seller a Merchant

Ramos v. Wheel Sports Center

409 N.Y.S.2d 505 (N.Y. Civ. Ct. 1978)

Mercorella, J.

In this non-jury action plaintiff/purchaser is seeking to recover from defendant/vendor the sum of $893 [about $3,200 in 2010 dollars] representing the payment made by plaintiff for a motorcycle.

The parties entered into a sales contract wherein defendant agreed to deliver a motorcycle to plaintiff by June 30, 1978, for the agreed price of $893. The motorcycle was subsequently stolen by looters during the infamous power blackout of July 11, 1977.

It is uncontroverted that plaintiff paid for the motorcycle in full; was given the papers necessary for registration and insurance and did in fact register the cycle and secure liability insurance prior to the loss although license plates were never affixed to the vehicle. It is also conceded that the loss occurred without any negligence on defendant's part.

Plaintiff testified that defendant's salesman was informed that plaintiff was leaving on vacation and plaintiff would come for the cycle when he returned. He further testified that he never saw or rode the vehicle. From the evidence adduced at trial it is apparent that plaintiff never exercised dominion or control over the vehicle.

Defendant's president testified that he had no knowledge of what transpired between his salesman and plaintiff nor why the cycle was not taken prior to its loss.

The sole issue presented to the Court is which party, under the facts disclosed, bears the risk of loss?

It is the opinion of this Court that defendant must bear the risk of loss under the provisions of Section 2-509(3) of the Uniform Commercial Code.

This section provides that "...the risk of loss passes to the buyer on his receipt of the goods if the seller is a merchant...." Section 2-103(1)(c) states that receipt of goods means taking physical possession of them. [Authors' note: UCC revisions have changed the rule so that risk of loss passes to the buyer on his receipt of the goods *irrespective* of whether the seller is a merchant or not. It is still 2-509(3), however.]

The provision tends more strongly to hold risk of loss on the seller than did the former Uniform Sales Act. Whether the contract involves delivery at the seller's place of business or at the situs of the goods, a merchant seller cannot transfer risk of loss and it remains on him until actual receipt by the buyer, even though full payment has been made and the buyer notified that the goods are at his disposal. The underlying theory is that a merchant who is to make physical delivery at his own place continues meanwhile to control the goods and can be expected to insure his interest in them.

The Court is also of the opinion that no bailee/bailor relationship, constructive or otherwise, existed between the parties.

Accordingly, let judgment be entered in favor of plaintiff for the sum of $893, together with interest, costs and disbursements.

CASE QUESTIONS

1. What caused the loss here, through no fault of either party?
2. What is the rationale for holding the merchant-seller liable in this circumstance?
3. Suppose instead that Ramos had purchased the motorcycle at a garage sale from an acquaintance and the same loss occurred. Who would bear the risk then?

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17.5: Summary and Exercises

Summary

Two significant questions lurk in the background of any sale: (1) when does title pass? and (2) who must bear the risk of loss if the goods are destroyed or damaged through no fault of either party?

In general, title passes when the buyer and the seller agree that it passes. If the buyer and the seller fail to specify the time at which title passes, Article 2 lays down four rules: (1) under a shipment contract, title passes when the seller places the goods with the carrier; (2) under a destination contract, title passes when the goods are tendered at the place of delivery; (3) under a contract calling for delivery of documents of title, title passes when the seller tenders documents of title, even if the goods are not physically moved; and (4) when no physical delivery or exchange of documents is called for, title passes when the contract is signed.

The buyer and the seller may also specify who must bear the risk of loss. But if they do not, Article 2 sets out these four rules: (1) when the seller must ship by carrier but not to any particular destination, risk passes to the buyer when the seller delivers the goods to the carrier; (2) when the goods must be transported to a particular destination, risk passes when the carrier tenders them at that destination; (3) if the goods are held by a bailee who has issued a negotiable document of title, risk passes when the buyer receives the document; (4) in other cases, risk of loss turns on whether the seller is a merchant. If he is a merchant, risk passes when the buyer receives the goods; if he is not a merchant, risk passes when the seller tenders the goods. These rules are modified when either of the parties breaches the contract. In general, unless the breach is cured, the risk of uninsured losses lies on the party who breached.

Either party may insure the goods if it has an insurable interest in them. The buyer has an insurable interest in goods identified to the contract—for example, by marking them in some manner. The seller has an insurable interest as long as he retains title or a security interest.

In fixing passage of title and risk of loss, the parties often use shorthand terminology whose meaning must be mastered to make sense of the contract. These terms include F.O.B.; F.A.S.; ex-ship; C.I.F.; C.F.; no arrival, no sale; sale on approval; and sale or return. Use of these terms in a contract can have a significant effect on title and risk of loss.

Sometimes goods are sold by nonowners. A person with voidable title has the power to transfer title to a good-faith purchaser for value. A merchant who deals in particular goods has the power to transfer all rights of one who entrusts to him goods of the kind. And a rightful owner may be estopped by his own acts from asserting title against an innocent purchaser.

EXERCISES

1. Betty from Baltimore contracts to purchase one hundred purple llama figurines from Sam of Syracuse. Sam is to send the goods by carrier and is not required to deliver them to Betty's Boutique, their destination. He ships them by train, which unfortunately crashes in Delaware. All the figurines are destroyed. Whose loss is it? Why?
2. In Exercise 1, assume that the train did not crash but that Sam's creditors attempted to seize the goods before their arrival. May the creditors do so? Why?
3. Hattie's Head Shop signed a written agreement with the Tangerine Computer Company to supply a Marilyn, a supercomputer with bubble memory, to total up its orders and pay its foreign agents. The contract provided that the computer was to be specially built and that Tangerine would deliver it by carrier to Hattie's ready to install no later than June 1. Tangerine engineers worked feverishly to comply with the contract terms. On May 25, the computer stood gleaming in Tangerine's shipping department. That night, before the trucks could depart, a tornado struck the factory and destroyed the computer intended for Hattie's. Whose loss is it? Why?
4. In Exercise 3, assume that the tornado did not strike but that Tangerine's creditors attempted to seize the computer. May they? Why?
5. On February 18, Clancy, who was in debt, took his stereo to Lucy's repair shop. Because Lucy and Clancy were old friends, Lucy didn't give him a receipt. On February 19, hounded by creditors, Clancy sold the stereo on credit to Grover, who was to pick it up on February 21 at Lucy's, pay Lucy the repair bill, and pay the balance of the purchase price to Clancy. Who is entitled to the radio if, on February 20, Clancy's creditor appears with the sheriff to seize the stereo from Lucy? Why?

6. Assume in Exercise 5 that, instead of the attempted seizure of the stereo by the creditor, Lucy's shop and the stereo are destroyed by fire on February 20. Must Grover still pay Clancy for the stereo? Why?
7. Cleo's Close-Outs, a wholesaler of discounted merchandise, offered Randy's Retailers a chance to buy all the contents of a shipment of bathtub toys just received. Cleo estimated that she had between five hundred and six hundred rubber ducks and wrote on October 21 offering them to Randy for only one dollar each if Randy would pick them up at Cleo's. Randy received the letter in the mail the next day and mailed his acceptance immediately. In the wee hours of the following morning, October 23, a fire consumed Cleo's warehouse, melting the ducks into an uneven soup. Assuming that Cleo was a merchant, who bears the loss? Why?
8. Plaintiff, a manufacturer of men's clothing in Los Angeles, contracted to sell a variety of clothing items to Defendant, Harrison's clothing store in Westport, Connecticut, "F.O.B. Los Angeles." Plaintiff delivered the goods to Trucking Company and received a bill of lading. When the goods arrived at Defendant's store about two weeks later, Mrs. Harrison, Defendant's wife, who was in charge of the store at the time, requested the truck driver to deliver the goods inside the door of the shop. The driver refused and ultimately drove away. The goods were lost. Defendant refused to pay for the goods and raised as a defense that "the Plaintiff refused to deliver the merchandise into the Defendant's place of business." Who wins and why?*Ninth Street East, Ltd. v. Harrison*, 259 A.2d 772 (Conn. 1968).
9. Jackson owned a number of guns and asked his friend Willard, who ran a country store, if Willard would let Jackson display the guns in the store for sale on consignment. Willard would get some compensation for his trouble. Willard agreed. Subsequently Willard's creditors seized assets of the store, including the guns. Jackson protested that they were his guns, not Willard's, and that the latter's creditors should keep their hands off them. Given no other facts, who wins?
10. Plaintiff advertised his car for sale. Roberts stopped by to look at it. He took it for a short test drive, returned to Plaintiff's house, and said, "I like it, but my wife needs to look at it before I buy it. I'll be back in less than half an hour." Roberts took the car and never returned. Plaintiff called the police, who later found the car in a neighboring state. Defendant had bought it from Roberts, who had presented him with forged registration papers. Plaintiff then sued Defendant to get the car back. Who wins?

SELF-TEST QUESTIONS

1. In a sale-on-approval contract
    1. the goods are intended primarily for the buyer's use
    2. the goods are intended primarily for resale
    3. the risk of loss is on the buyer
    4. the buyer obtains title upon receipt of the goods
2. As a general rule
    1. goods cannot be sold by persons with voidable title
    2. a rightful owner cannot be estopped from asserting title against an innocent purchaser
    3. a merchant cannot transfer the rights of a person who entrusts goods to him
    4. a person with voidable title has the power to transfer title to a good-faith purchaser for value
3. In general, title passes
    1. to a buyer when the contract is signed
    2. when the buyer and the seller agree that it passes
    3. to a buyer when the seller receives payment for goods
    4. under none of the above conditions
4. When a destination contract does not specify when title is to pass, it passes
    1. when the goods are shipped
    2. when the contract is signed
    3. when the buyer pays for the goods
    4. when the seller tenders delivery
5. In a C.I.F. contract
    1. the seller must obtain insurance
    2. the buyer must obtain insurance
    3. the seller has fewer duties than with a C.F. contract
    4. title passes to the buyer when the seller tenders delivery

SELF-TEST AnswerS

1. a
2. d

3. b
4. d
5. a

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18: PERFORMANCE AND REMEDIES

Learning Objectives

After reading this chapter, you should understand the following:

1. What performance is expected of the seller in a sales contract
2. What performance is expected of the buyer in a sales contract
3. What rights and duties the buyer has if there is a nonconforming delivery
4. How, in general, the UCC approaches remedies
5. What the seller's remedies are for breach by the buyer
6. What the buyer's remedies are for breach by the seller
7. What excuses the UCC provides for nonperformance

In Part II, we examined contract performance and remedies under common law. In this chapter, we examine performance and remedies under Article 2, the law of sales, of the Uniform Commercial Code (UCC). In the next chapter, we cover special remedies for those damaged or injured by defective products.

The parties often set out in their contracts the details of performance. These include price terms and terms of delivery—where the goods are to be delivered, when, and how. If the parties fail to list these terms, the rules studied in this chapter will determine the parties' obligations: the parties may agree; if they do not, the UCC rules kick in as the default. In any event, the parties have an obligation to act in good faith.

18.1: Performance by the Seller

18.2: Performance by Buyer

18.3: Remedies

18.4: Excuses for Nonperformance

18.5: Cases

18.6: Summary and Exercises

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18.1: Performance by the Seller

LEARNING OBJECTIVE

1. Understand what is meant when it is said the seller has a duty to "make a timely delivery of conforming goods."

The Seller's Duty in General

The general duty of the seller is this: to make a timely delivery of conforming goods.Uniform Commercial Code, Sections 2-301and 2-309.

The CISG, Article 30, says, "The seller must deliver the goods, hand over any documents relating to them and transfer the property in the goods, as required by the contract and this Convention."

Analysis of the Seller's Duty

Time for Delivery

The parties to a contract may agree in advance on the specific time when delivery must be made. This can be accomplished through clear contractual language such as:

- *"Delivery is due on or before July 8."*
- *"The first of 12 installments is due on or before July 8."*

Both statements leave little room for dispute because the obligation is definite.

If the parties do not specify the time for delivery, the Uniform Commercial Code (UCC) fills the gap. Under **UCC § 2-309**, *"The time for shipment or any other action under a contract if not provided for in this Article or agreed upon shall be a reasonable time."*

What counts as a *reasonable time* depends on the circumstances. Comment 1 to § 2-309 explains that reasonableness turns on commercial standards, good faith, and the nature of the transaction. For instance, what is "reasonable" in the sale of fresh produce will differ from what is "reasonable" in the sale of heavy machinery.

Internationally, the **United Nations Convention on Contracts for the International Sale of Goods (CISG)** provides a similar framework. Article 33 states that the seller must deliver the goods:

1. **On the fixed date** if a date is specified in the contract;
2. **Within a fixed period** if a period of time is set, unless the circumstances indicate that the buyer is to choose the date; or
3. **Within a reasonable time** after the contract is concluded, if neither a date nor a period is set.

In short, both the UCC and CISG emphasize the importance of certainty when delivery terms are agreed upon, and rely on the concept of *reasonableness* when they are not.

Place of Delivery

The parties to a sales contract may specify how and where delivery is to be accomplished. If they do not, the **UCC** provides default rules to fill the gap.

Similarly, the **CISG (Article 31)** establishes the seller's obligations regarding the place of delivery:

1. **Carriage of Goods:** If the contract involves shipment, the seller's obligation is satisfied when the goods are handed over to the first carrier for transmission to the buyer.
   - *Example: A seller in Chicago ships machinery to a buyer in Berlin. Delivery is complete when the goods are given to the shipping company in Chicago.*
2. **Goods Located Elsewhere:** If the goods are tied to a specific location (for example, stored in a warehouse), the seller must place them at the buyer's disposal at that location.
   - *Example: Grain stored in a Kansas silo must be made available to the buyer at that silo.*
3. **Other Cases:** In all other situations, delivery is satisfied by placing the goods at the buyer's disposal at the seller's place of business at the time the contract was formed.
   - *Example: If no shipment or special location is involved, a clothing manufacturer in Milan fulfills its delivery obligation by making the goods available at its own business premises.*

Both the UCC and CISG seek to provide predictable default rules when the parties fail to agree. This reinforces the importance of drafting clear delivery terms, but also ensures the contract will remain enforceable even if silent on these points.

By Agreement

The parties are free to use whatever language they wish to establish delivery terms in their contract. As long as the agreement is clear, courts and arbitrators will generally enforce the parties' chosen terms. For example, they may state, *"Delivery shall occur at the buyer's warehouse on or before July 8,"* or *"The seller will ship the goods FOB Port of Los Angeles."*

In short, delivery terms are a matter of contract freedom—so long as the intent of the parties can be determined, their language governs.

If There Is No Delivery Agreement

If the parties do not clearly specify delivery terms—or if their agreement uses only formulaic boilerplate—the **UCC** provides default rules to guide performance. This is important because standardized form contracts are common in commerce and often leave details unstated.

As you may recall from chapter on*Title and Risk of Loss*, title passes when the seller has completed their delivery obligations. Those obligations depend on the type of contract: a **shipment contract**, a **destination contract**, or a contract where the goods are **not to be moved** (because they are held by a bailee). In all cases, delivery must occur within a **reasonable time**, and the seller's tender (offer to deliver) must remain open for a reasonable period. The buyer, in turn, must provide facilities reasonably suited for receiving the goods (UCC § 2-503). If the contract is completely silent about delivery, the default place of delivery is the **seller's place of business** or, if none, the seller's residence (UCC § 2-308).

Conforming Goods

The seller's fundamental obligation is to tender goods that conform in *every respect* to the contract. This duty is commonly known as the **perfect tender rule** (UCC § 2-601). Unless otherwise agreed by the parties, the seller must deliver goods that match the contract terms in quality, quantity, description, timing, manner of delivery, packaging, and documentation.

Illustrations of the Seller's Duty

1. **Quality/Description**
   - *Example:* If the contract requires "Grade A California almonds," the seller cannot ship a mix of Grade A and Grade B.
2. **Correct Goods**
   - *Example:* If the buyer orders Model X laptops, the seller must deliver Model X—not Model Y or a substitute, unless expressly authorized.
3. **Quantity**
   - *Example:* A contract for 1,000 units obligates the seller to tender 1,000—not 950, not 1,050.
4. **Time of Tender**
   - *Example:* If the contract specifies delivery "on or before June 1," a June 3 delivery fails to conform.
5. **Manner of Delivery and Packaging**
   - *Example:* Fragile glassware contracted as "retail-ready" must be packaged appropriately for safe transit.

6. **Documents**
   - *Example:* In a C.I.F. sale, the seller must provide a clean bill of lading, an insurance certificate, and an invoice. Missing documents make the tender nonconforming.
7. **Samples or Models**
   - *Example:* If goods are sold "as per sample," the delivered product must match the approved sample in quality and appearance.

Seller's Right to Cure (UCC § 2-508)

Although the perfect tender rule is strict, the UCC softens it by allowing the seller an opportunity to cure:

- **Within the contract time:** If time for performance remains, the seller may, upon seasonable notice, tender conforming goods in place of nonconforming ones.
- **Beyond the contract time (reasonable belief):** If the seller had reasonable grounds to believe the nonconforming tender would be acceptable, the seller may, with notice, substitute conforming goods within a further reasonable time.

Example: If past dealings show the buyer previously accepted minor deviations with a price allowance, the seller may reasonably believe a similar shipment would be acceptable—and may cure if the buyer rejects.

Installment Contracts (UCC § 2-612)

In installment contracts, the seller's duty is somewhat less rigid. A nonconforming installment may be cured if the seller can make it conform. Only if a nonconformity substantially impairs the value of the entire contract does the seller's duty fail altogether.

Example: Delivering one defective installment in a year-long supply contract may be cured. However, repeated serious nonconformities that undermine the whole arrangement may excuse the buyer from continuing.

KEY TAKEAWAY

The seller's obligation under the UCC is to make a timely delivery of conforming goods. For each element of the duty—timely, delivery, conforming goods—the parties may agree in their contract. If they do not, the UCC fills in default rules.

EXERCISES

1. If the parties do not specify a time for delivery, what is the UCC's default position?
2. What are the seller's obligations in an F.O.B. shipment contract? In an F.O.B. destination contract?
3. Compare the UCC's perfect tender rule to the common-law substantial performance doctrine.

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18.2: Performance by Buyer

LEARNING OBJECTIVES

1. Understand what the general duties of the buyer are.
2. Recognize what rights the buyer has if the seller tenders a nonconforming delivery.

General Duties of Buyer

The buyer's primary obligations under the UCC are to **inspect, accept, and pay** for the goods (UCC §§ 2-301, 2-513). These duties arise only after the seller has properly tendered delivery. In other words, the buyer is not required to perform unless and until the seller has first carried out the seller's delivery obligations.

Inspection allows the buyer to determine whether the goods conform to the contract. Acceptance follows if the goods are conforming—or if the buyer chooses to accept them despite nonconformity. Payment is then due according to the terms of the contract.

Inspection

Under **UCC §§ 2-513(1) and (2)**, the buyer has a qualified right to inspect goods before acceptance. This right ensures that the buyer has a fair opportunity to determine whether the goods conform to the contract. If the goods are nonconforming, the buyer may reject them and refuse payment.

However, the right to inspect is not absolute. It is subject to three key exceptions:

1. **Waiver by Agreement**
   The parties may agree that payment is due before inspection. In such cases, the buyer must pay upon delivery, unless the nonconformity is so obvious that no inspection is required to detect it. Importantly, making payment under these terms does not equal acceptance—the buyer still retains the right to inspect and later reject the goods.
   - *Example:* A buyer agrees to pay for sealed cases of canned goods upon delivery. Payment is required before inspection, but the buyer may later open the cases and reject them if the cans are rusted or mislabeled.
2. **C.O.D. Deliveries (Cash on Delivery)**
   When goods are shipped C.O.D., the buyer must pay upon delivery to obtain possession. Inspection must wait until after payment.
   - *Example:* A furniture seller ships goods C.O.D.; the buyer must pay the carrier before opening the packages to inspect the tables.
3. **Payment Against Documents of Title**
   In documentary sales, payment is required upon presentation of the documents of title (such as a bill of lading) rather than after inspection of the actual goods.
   - *Example:* A buyer of grain under a C.I.F. contract must pay against shipping documents, even before the grain itself is available for inspection.

Finally, if the buyer fails to inspect, or fails to discover a defect that a reasonable inspection would have revealed, the buyer generally cannot later revoke acceptance—though exceptions apply for latent defects that were not discoverable at the time of inspection.

Acceptance

In sales law, **acceptance** means that the buyer takes the goods as fulfilling the contract—even if they are imperfect. While the concept seems straightforward, complications often arise when delivery is improper or nonconforming.

Under **UCC § 2-606(1)**, acceptance occurs in any of three ways:

1. **By Words**
   After a reasonable opportunity to inspect, the buyer communicates to the seller that the goods conform, or that the buyer will keep them despite any nonconformity.
   - *Example:* A buyer receives 1,000 widgets, finds that 20 are defective, but notifies the seller: "I'll keep them anyway."
2. **By Silence**
   If, after a reasonable opportunity to inspect, the buyer does not reject the goods, silence is treated as acceptance.
   - *Example:* A buyer takes delivery of office chairs and leaves them in the warehouse without objection. After a reasonable period, failure to reject counts as acceptance.
3. **By Action**
   If the buyer acts in a way inconsistent with the seller's ownership, acceptance is inferred.
   - *Example:* A buyer resells delivered goods to another party, or begins using machinery in production, even before formally communicating acceptance.

Once the buyer accepts, **two important consequences follow** (UCC § 2-607):

- The buyer is obligated to pay for the goods at the contract rate.
- The buyer loses the right to reject the goods, even if they are nonconforming.

Acceptance, however, is not always final. The UCC provides limited exceptions—such as the buyer's right to **revoke acceptance** if a latent defect is later discovered that substantially impairs the value of the goods (UCC § 2-608).

Payment

The parties are free to agree on what constitutes payment and when it must be made. For example, a contract may specify payment by electronic transfer within 10 days of delivery, or payment in installments tied to stages of performance. Courts will generally enforce whatever terms the parties negotiate, so long as they are clear.

If the contract is silent, the **UCC provides default rules** (UCC §§ 2-511, 2-512):

- **Time of Payment:** Payment is due at the time and place the buyer is to receive the goods, unless the parties agree otherwise. In other words, the seller's duty to deliver and the buyer's duty to pay are concurrent conditions.
- **Form of Payment:** Payment must be made in money (cash, check, or equivalent) unless the parties agree to another method. A check is sufficient unless the seller demands cash, in which case the buyer must be given a reasonable opportunity to obtain it.
- **Payment Before Inspection:** Generally, the buyer has the right to inspect before payment. However, there are exceptions where payment must be made prior to inspection, such as C.O.D. shipments or documentary sales.

Example: A buyer orders machinery, and the contract says nothing about payment. Under the UCC, the buyer must pay when the machinery is tendered at the seller's warehouse, unless the parties later agree to different terms.

A Buyer's Right on Nonconforming Delivery

When goods fail to conform to the contract, the buyer is not required to accept them. The **UCC perfect tender rule** (UCC § 2-601; § 2A-509 for leases) gives the buyer several options:

1. **Reject the Whole Shipment**
   - *Example:* A buyer orders 500 "Grade A" apples. The seller delivers mixed quality, including "Grade B." The buyer may reject the entire shipment.
2. **Accept the Whole Shipment**
   - *Example:* A buyer may choose to accept the goods despite defects, perhaps negotiating a price allowance or planning to use them anyway.
3. **Accept Any Commercial Unit and Reject the Rest**
   - A "commercial unit" is something treated in the trade as a single whole—such as a bale of cotton, a machine, or a case of bottles.
   - *Example:* A buyer contracts for 10 machines, finds 2 are defective, and keeps 8 while rejecting 2.

4. **Revoke Acceptance (UCC § 2-608)**
   In limited circumstances, a buyer who has already accepted may later revoke if:

   - The nonconformity substantially impairs the value of the goods, and
   - (a) The defect was difficult to discover at the time of acceptance (latent defect), or
   - (b) The seller assured the buyer that the goods would be cured but failed to do so.
   - *Example:* A buyer accepts a shipment of industrial pumps that appear fine on inspection. Weeks later, hidden defects cause repeated breakdowns. The buyer may revoke acceptance.

Rejection and a Buyer's Duties after Rejection

Under **UCC § 2-601(a)**, the buyer may reject goods if the seller fails to make a *perfect tender*. Rejection must be made **within a reasonable time** after delivery or tender, and the buyer must seasonably notify the seller.

Effect of Rejection

Once rejection is made, the buyer may not treat the goods as his own. If the buyer has already taken possession, he must hold the goods with **reasonable care** so that the seller has an opportunity to remove them.

Duties of Non-Merchant Buyers

A non-merchant buyer's duty is limited to holding the goods for a reasonable time and making them available to the seller.

- *Example:* A consumer receives the wrong size refrigerator and promptly rejects it. She must take reasonable steps to keep it safe until the seller picks it up, but she is not required to resell or otherwise dispose of it.

Duties of Merchant Buyers

If the buyer is a **merchant**, additional duties apply:

- The buyer must follow any reasonable instructions from the seller about how to handle or dispose of the goods.
- If the seller gives no instructions and the goods are **perishable or likely to decline in value quickly**, the merchant must make reasonable efforts to sell them for the seller's account. The merchant is entitled to reimbursement for expenses and a reasonable commission.
- *Example:* A grocery wholesaler rejects a truckload of strawberries because they are spoiled. With no instructions from the seller, the wholesaler must attempt to resell the berries quickly to minimize the seller's loss.

Options if Seller Fails to Provide Instructions

Whether merchant or non-merchant, if the seller fails to provide instructions within a reasonable time, the buyer has the right to:

- Store the goods,
- Reship them to the seller, or
- Resell them on the seller's account.

Importantly, such actions are not treated as **acceptance** of the goods or as wrongful **conversion**. They are simply measures to protect the seller's property interest while ensuring the buyer is compensated for reasonable efforts.

Acceptance of a Nonconforming Delivery

The buyer is not required to reject goods simply because they are nonconforming. Instead, the buyer may choose to **accept the goods as delivered**, with or without an adjustment for the nonconformity.

Acceptance Without Allowance

The buyer may decide to keep the goods and pay the full contract price, even though they do not strictly conform.

- *Example:* A buyer orders 1,000 red pens but receives 990 red and 10 blue. The buyer may keep all 1,000 and pay the full price, treating the variation as insignificant.

Acceptance With Allowance

The buyer may also accept the goods while negotiating or claiming an allowance (a reduction in the contract price) for the defect. This right is recognized under **UCC § 2-714**, which permits a buyer to recover damages for nonconformity after acceptance.

- *Example:* A retailer orders leather handbags but receives a batch with minor scuff marks. The retailer may keep the goods, sell them at a discount, and deduct the diminished value from the contract price.

Practical Importance

In commercial practice, acceptance of nonconforming goods is common when rejection would cause delays, shortages, or lost sales. The UCC balances strict contract rights with flexibility, allowing parties to move forward with performance while still addressing the nonconformity through price adjustments or damages.

Acceptance of Part of a Nonconforming Delivery

The buyer may accept any commercial unit and reject the rest if she wants to. A **commercial unit** means "such a unit of goods as by commercial usage is a single whole for purposes of sale and division of which materially impairs its character or value on the market or in use. A commercial unit may be a single article (as a machine), a set of articles (as a suite of furniture or an assortment of sizes), a quantity (as a bale, gross, or carload), or any other unit treated in use or in the relevant market as a single whole."Uniform Commercial Code, Sections 2-105 and 2A103(1).

Installment Sales

An **installment contract** is one that requires delivery of goods in separate lots, with each lot separately accepted. This type of contract complicates the question: *What right does the buyer have to accept or reject when the seller fails to deliver properly?*

Under **UCC § 2-612**, the rules are as follows:

1. **Rejecting an Installment**
   - The buyer may reject a nonconforming installment if the defect **substantially impairs the value of that installment** and cannot be cured.
   - However, if the seller provides **adequate assurances** that the defect will be cured, the buyer must accept the installment—unless the defect substantially impairs the value of the *whole contract*.
2. **Rejecting the Entire Contract**
   - The buyer may reject the entire contract only if the nonconformity or default in one or more installments **substantially impairs the value of the whole contract**.

Example: Corner Gas Station

Suppose Corner Gas Station contracts to buy **12,000 gallons** of gasoline from Seller, deliverable in **twelve monthly installments** of 1,000 gallons each, with payment due three days after delivery.

- **Month 3 Problem:** Seller delivers only 500 gallons on the first day of the month and promises the remaining 500 gallons midmonth.
  - If Corner Gas knows it will not use the gasoline before midmonth, the short delivery does **not** substantially impair the value of that installment, and rejection is not justified.
  - If, however, Corner Gas needs the full 1,000 gallons immediately to avoid running short—and cannot purchase elsewhere without agreeing to a burdensome supply contract—then the short delivery **does** substantially impair the installment, and rejection is proper.
- **Rejecting the Entire Contract:**
  - If Seller's failure puts Corner Gas in a position where its overall supply contract is no longer workable—for example, if other suppliers will only sell under a year-long commitment, or if rising market prices mean Corner Gas will face significant losses—the breach may be treated as a substantial impairment of the **whole contract**. In that case, Corner Gas may reject all future deliveries and seek damages equal to the difference between the contract price and the higher replacement cost.

Key Point:
In installment contracts, the buyer's rights to reject are **narrower** than under the perfect tender rule. Rejection depends on whether the nonconformity substantially impairs the value of an installment or the contract as a whole.

Revocation of Acceptance

Revocation of acceptance allows a buyer who has already accepted goods to later return them and recover the purchase price. This remedy is narrower than rejection, because acceptance usually signals finality. Under **UCC § 2-608**, however, a buyer may revoke acceptance if the goods' nonconformity **substantially impairs their value** and one of the following applies:

1. The buyer accepted the goods **on the reasonable assumption that the defect would be cured**, but it was not cured within a reasonable time; or
2. The buyer accepted the goods **without discovering a latent defect** that could not reasonably have been discovered before acceptance.

Revocation must occur within a reasonable time after the buyer discovers (or should have discovered) the grounds for it, and before the goods undergo substantial change not caused by their own defects.

Case Illustration 1: Failure to Cure

North River Homes, Inc. v. Borsage (Miss. 1992)

- **Facts:** The Borsages purchased a mobile home described as "the Cadillac of mobile homes." After moving in, they discovered numerous defects—leaks, warped doors, defective heating and cooling, chipped cabinets, collapsing furniture, and even mold. Many defects were hidden at the time of purchase (they inspected at night, without lights). The seller repeatedly promised repairs, but they were either delayed or poorly performed, including taping a hole in the home's underside with masking tape and puncturing the septic line. After 31 months of frustration, the Borsages revoked their acceptance and sued for the purchase price.
- **Holding:** The court upheld revocation, reasoning that repeated assurances of repair justified the buyers' patience and that the defects substantially impaired the value of the home. The fact that they continued living in the home did not bar revocation, as they had nowhere else to live.

Key Point: If a buyer accepts goods believing defects will be cured, but the seller fails to cure in a reasonable time, revocation is proper.

Case Illustration 2: Latent Defect

Colonial Dodge v. Miller (Mich. 1984)

- **Facts:** Clarence Miller purchased a new Dodge station wagon with a heavy-duty trailer package that included wide tires and a spare. The evening after purchase, his wife discovered the spare tire was missing. When Miller complained, he was told no spare was available due to a labor strike. Concerned about his safety (he frequently drove long distances on Detroit freeways at night), Miller returned the car and revoked acceptance. The dealer argued the missing tire did not substantially impair the car's value.
- **Holding:** The Michigan Supreme Court sided with Miller. Because the missing spare substantially impaired the value of the car *to him*, given his driving needs and safety concerns, revocation was justified. The defect was latent, concealed under a fastened panel, and not discoverable on a reasonable inspection.

Key Point: Even a single missing part may constitute substantial impairment if it significantly affects the goods' value to the buyer, especially when tied to safety or intended use.

Summary

Revocation of acceptance is a powerful but limited remedy. It protects buyers who either (1) relied on the seller's promise to cure, or (2) were misled by latent defects that could not reasonably be discovered before acceptance. Both cases illustrate that what counts as "substantial impairment" is judged from the perspective of the particular buyer and the circumstances of use.

KEY TAKEAWAY

The duty of the buyer in a sales contract is to inspect, accept, and pay. Failure to discover a defect that an inspection would have revealed is a waiver of right to complain. Normally the goods are conforming and the buyer accepts them, but upon discovery of a defect the buyer may reject the whole nonconforming delivery, part of it (the buyer has some duties if she has possession of the rejected goods), or in some cases reject one installment of an installment sale or, if one defective installment is serious enough to vitiate the whole contract, the buyer may consider the contract terminated. If goods have been accepted because the seller promised to fix defects or because the defects were latent, then the buyer may revoke the acceptance where the nonconformity substantially impairs the value of the contract to the buyer.

EXERCISES

1. If a buyer takes possession of goods and shortly thereafter discovers they are nonconforming, what duty does the nonmerchant buyer have with respect to the goods? What duty does the merchant buyer have with respect to the goods?
2. What is the difference between rejection and revocation?
3. Under what circumstances will a defective installment allow the buyer to reject that installment? Under what circumstances would a defective installment allow the buyer to terminate the contract?

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18.3: Remedies

LEARNING OBJECTIVES

1. Understand what purpose remedies serve under the UCC.
2. Be able to see when the parties' agreements as to limited remedies fail under the UCC.
3. Recognize what the seller's remedies are.
4. Recognize what the buyer's remedies are.

Remedies in General

General Policy of the UCC

The **Uniform Commercial Code (UCC)** follows a broad principle of fairness: remedies should put the aggrieved party in as good a position as if the other party had fully performed. In other words, the goal is to make the injured party "whole," as though there had been a timely delivery of conforming goods.

The UCC emphasizes **liberal construction** of its provisions to achieve this policy whenever possible. Accordingly, it provides an array of remedies:

- **For the seller** when the buyer breaches (e.g., refusing delivery or failing to pay).
- **For the buyer** when the seller breaches (e.g., failing to deliver, delivering late, or delivering nonconforming goods).

These remedies are designed to be flexible, recognizing the diverse realities of commercial practice.

General Policy of the CISG

The **United Nations Convention on Contracts for the International Sale of Goods (CISG)** articulates a similar policy in **Article 74**:

> "Damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach. Such damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters of which he then knew or ought to have known, as a possible consequence of the breach of contract."

Thus, like the UCC, the CISG aims to make the injured party whole—but it also imposes a **foreseeability limit** on damages, echoing the rule in *Hadley v. Baxendale* from common law contract principles.

Contractual Limits on Remedies

The **UCC strongly favors freedom of contract**. Parties are generally free to structure not only the details of performance but also the remedies available in case of breach. As long as the agreement is not unconscionable, courts will enforce the parties' choices (UCC §§ 2-719(1), 2A-503(1)).

Limiting Remedies

The parties may expressly limit remedies. A common contractual clause might read:

> "Seller's sole obligation in the event goods are deemed defective by the seller is to replace a like quantity of nondefective goods."

Under **UCC § 2-719(1)(b)** and **UCC § 2A-503(2)**, such a clause is enforceable unless it expressly states that it is the **exclusive**

remedy; otherwise, it is optional and does not bar other UCC remedies.

The Baseline Rule

Despite this freedom, the UCC insists on one baseline principle: every sales contract must provide a **"fair quantum of remedy"** for breach. As the official comment explains, if parties intend to make a valid sales contract under the UCC, they cannot eliminate remedies entirely.

Three Important Limits on Freedom to Restrict Remedies

1. **Failure of Essential Purpose**
   If the agreed-upon remedy fails or proves ineffective, the UCC's default remedies apply instead (UCC §§ 2-719(2), 2A-503(2)).

   - *Example:* A contract limits the seller's obligation to replacing defective goods. If repeated replacements fail to fix the defect, the limitation "fails of its essential purpose," and the buyer may pursue broader UCC remedies such as damages.

2. **Consequential Damages**
   Consequential damages (such as lost profits) may be limited or excluded by agreement, except when the limitation would be unconscionable (UCC §§ 2-719(3), 2A-503(2)).

   - In consumer contracts, a limitation of damages for **personal injury** is *prima facie* unconscionable.
   - In commercial contracts, however, limitations on consequential damages are usually permissible.

3. **Liquidated Damages**
   The parties may agree in advance to **liquidated damages**—a set sum or formula for damages upon breach—if the amount is reasonable in light of:

   - The anticipated or actual harm caused by the breach,
   - The difficulty of proving actual damages, and
   - The inconvenience or nonfeasibility of obtaining another adequate remedy (UCC § 2-718).

   An unreasonably large amount is void as a penalty.

   Leases: The rule is slightly different under **UCC § 2A-504(1)**, which allows liquidated damages "at an amount or by a formula that is reasonable in light of the then anticipated harm caused" by the breach—omitting the other considerations listed for sales contracts.

Statute of Limitations

The **UCC** sets a four-year statute of limitations for breach of any sales contract (UCC § 2-725). The parties may agree to shorten this period to no less than **one year**, but they may not extend it beyond four years.

- *Example:* A buyer and seller may contractually agree that any lawsuit for breach must be brought within two years of delivery, but they cannot agree to allow claims after five years.

For leases, **UCC § 2A-506(1)** establishes a similar four-year limitation but does not prohibit parties from agreeing to extend the period.

When Does the Cause of Action Accrue?

Under **UCC § 2-725(2)**, the cause of action accrues when the breach occurs—**regardless of whether the aggrieved party knows of the breach**.

- **General Rule:** A breach of warranty occurs when tender of delivery is made.
- **Exception (Future Performance):** If a warranty explicitly extends to future performance (for example, a five-year warranty on an appliance), and the defect is not discoverable until later, the statute of limitations begins to run when the breach is or should have been discovered.

Example 1: A seller delivers machinery on June 1, 2024. The statute of limitations begins on that date, even if the buyer does not discover the defect until June 2026. The latest the buyer could sue is June 2028, unless the warranty explicitly covered future performance.

Example 2: A refrigerator sold with a five-year warranty against compressor failure develops a defect in year four. The statute begins to run at the time of failure (discovery), not at the time of original delivery.

Article 2A-506(2) is similar to 2-725(2).

Seller's Remedies: Article 2 in General

When the buyer defaults, **UCC § 2-703** provides the seller with a broad menu of remedies. Buyer defaults may take the form of:

- Wrongful rejection of goods,
- Revocation of acceptance,
- Failure to make payment when due, or
- Repudiation of the contract (as to part or all of the goods).

In such cases, with respect to the goods directly affected—and if the breach is of the whole contract, with respect to the entire undelivered balance—the aggrieved seller may:

1. **Withhold delivery** of the goods.
2. **Stop delivery** of goods in the hands of a bailee or carrier.
3. **Identify** goods to the contract if not already identified.
4. **Reclaim** goods if the buyer is insolvent.
5. **Resell** the goods and recover damages.
6. **Recover damages** for non-acceptance or repudiation.
7. **Recover the price** in a proper case.
8. **Cancel** the contract.

These remedies fall into three categories:

- **Control over the goods** (withholding, stopping delivery, identifying goods, reclaiming).
- **Rights to money damages** (resale damages, damages for non-acceptance or repudiation, recovery of the price).
- **Contract termination** (cancellation).

CISG Comparison

The **CISG** provides similar protections. Under **Article 61 and following**, if the buyer fails to perform obligations, the seller may:

- Require the buyer to pay the price.
- Fix an additional reasonable time for the buyer to perform. During this period, the seller may not resort to other remedies unless the buyer indicates he will not perform.
- Declare the contract avoided if the buyer's failure amounts to a **fundamental breach** or if the buyer fails to perform within the additional period granted.
- Recover damages for losses caused by the breach.

The CISG's framework emphasizes **good faith and notice** by requiring the seller to give the buyer an opportunity to cure before pursuing more drastic remedies, unless the breach is fundamental.

Example: Howard and Bunker

To illustrate how the UCC's remedies apply, consider this scenario:

- **Seller (Howard, Los Angeles):** Agrees to sell 100 prints of a Pieter Bruegel painting, plus the original.
- **Buyer (Bunker, Dallas):** Agrees to purchase the goods.

- **Status of goods:**
  - 25 prints already delivered to Bunker.
  - 25 prints en route by common carrier.
  - 25 prints completed but not yet shipped.
  - 25 prints still in production.
  - The original painting is hanging in Howard's living room.

In the sections that follow, we will examine Howard's remedies if Bunker breaches the contract—including remedies tied to insolvency.

Remedies on Breach on Buyer's Breach

When a buyer wrongfully rejects goods, revokes acceptance, fails to make payment, or repudiates the contract, the UCC provides the seller with a **cumulative set of remedies** (UCC §§ 2-703, 2A-523). The seller does not need to elect only one remedy; multiple remedies may be pursued together as commercially appropriate.

Using our example: **Howard (Los Angeles)** contracts to sell **100 prints and an original Bruegel painting** to **Bunker (Dallas)**. Bunker repudiates by e-mail, refusing to pay or accept delivery. Here are Howard's remedies:

Withhold Further Delivery

Howard may refuse to ship the 25 prints already completed but not yet dispatched.

Stop Delivery

Howard may instruct the carrier to stop delivery of the 25 prints currently en route.

- If Bunker is insolvent, Howard may stop delivery of *any shipment* with a bailee or carrier.
- If Bunker is solvent, Howard may stop only **bulk shipments** (carload, truckload, planeload, etc.) to avoid undue burden on carriers.

Identify Goods to the Contract

Howard may "identify" specific goods as those intended for the contract, even if they were not specified earlier (UCC § 2-704).

- He could designate 100 of his 500 prints as the contracted goods.
- He may also complete the final 25 prints still in production if, in his reasonable commercial judgment, doing so will allow resale and minimize losses.

Resell the Goods

Howard may resell the 75 prints in his possession plus the original painting. If resale is done **in good faith and in a commercially reasonable manner** (UCC § 2-706), Howard may recover:

- The difference between the resale price and the contract price,
- Plus incidental damages,
- Less any expenses saved (e.g., avoided shipping).

Example: If the contract price was $100 per print plus $10,000 for the original, but resale brings only $75 per print and $8,000 for the original, Howard may recover the shortfall plus incidental expenses.

Resale may be public (auction) or private. If public, Howard must notify Bunker (unless goods are perishable), make the goods available for inspection, and permit Bunker to bid.

Recover Damages (Market Price Differential)

Alternatively, Howard may recover damages equal to the difference between the **market price at the time and place of tender** and the contract price, plus incidental damages, less expenses saved (UCC § 2-708(1)).

Recover Lost Profits

If resale or market damages do not make Howard whole, he may recover **lost profits** (UCC § 2-708(2)). This is especially important for **lost-volume sellers**—sellers who could have made the resale *in addition to* the original sale.

- *Example:* If Howard could easily sell more prints at the same price, the second sale does not substitute for Bunker's default; Howard lost a volume sale and is entitled to the profit he would have made on Bunker's purchase.

Recover the Price

Howard may sue for the price (UCC § 2-709) if:

- Bunker holds the 25 prints already delivered,
- The risk of loss has shifted to Bunker (e.g., if a shipment contract was agreed to and goods were destroyed en route), or
- No market exists for the prints, and resale is impracticable.

If the price is recovered, Howard must hold unsold goods for Bunker and credit any resale proceeds against the judgment.

Cancel the Contract

Finally, Howard may declare the contract cancelled (UCC § 2-703(f), 2A-524). Cancellation ends the seller's obligations while preserving the right to damages for breach.

CISG Comparison

The **CISG** follows a similar framework (Articles 61–64), allowing the seller to:

- Require payment,
- Fix an additional period for the buyer to perform,
- Avoid the contract if the breach is fundamental or not cured in the additional period, and
- Recover damages.

Seller's Remedies on Buyer's Insolvency

Even without breach, if the seller discovers the buyer is **insolvent** (UCC § 1-201(23)), additional protections apply (UCC § 2-702):

- Howard may refuse to deliver further goods unless Bunker pays **cash**, not only for future shipments but also for goods already delivered.
- If Howard discovers insolvency within **10 days** of delivering the first 25 prints, he may demand to reclaim them.
  - If Bunker falsely represented solvency within three months prior to delivery, the 10-day limit does not apply.
- Reclamation is limited: Howard cannot reclaim goods that Bunker has already resold to a good-faith purchaser.

In leases: Because the lessor retains title, repossession is simpler. Under **UCC § 2A-525(2)**, the lessor may repossess goods directly upon default.

Buyer's Remedies

Thus far, we have focused on the seller's remedies. But what happens if **Howard, the seller, breaches** instead of Bunker? In that case, the UCC shifts the focus to the **buyer's remedies**, which we explore in the next section.

In General

When the seller defaults, the **UCC** provides the buyer with a broad array of remedies. A seller may default by:

1. **Repudiating** the contract (announcing in advance that he will not perform),
2. **Failing to deliver** the goods, or
3. **Delivering or tendering nonconforming goods.**

Under **UCC § 2-711**, when the seller fails to deliver, repudiates, or when the buyer rightfully rejects or revokes acceptance, the buyer may:

1. Cancel the contract,
2. Recover any price already paid,
3. "Cover" by buying substitute goods and recover damages,
4. Recover damages for nondelivery,
5. Recover the goods if identified,
6. In proper cases, obtain **specific performance** or **replevin**,
7. Assert a **security interest** in rejected goods in his possession,
8. Recover damages for accepted nonconforming goods, plus
9. Recover **incidental** and **consequential damages**.

CISG Comparison

The **CISG** (Articles 45–51) provides similar remedies but with some differences in emphasis:

- The buyer may declare the contract avoided if the breach is **fundamental**.
- The buyer may require performance or delivery of substitute goods if nonconformity is substantial.
- The buyer may demand repair if reasonable.
- The buyer may fix an additional period of time for performance.
- In case of nonconforming delivery, the buyer may reduce the price proportionally.

Remedies When Goods Are Not Received

Cancel the Contract

If goods have not been received (or if acceptance is rightfully revoked), the buyer may cancel the contract. Upon cancellation, the buyer is excused from further obligations (UCC §§ 2-711(1), 2-106).

Recover the Price Paid

Whether or not the buyer cancels, any portion of the purchase price already paid may be recovered.

Cover

The buyer may obtain substitute goods in good faith and in a commercially reasonable manner. Damages are the difference between the **cover price** and the **contract price**, plus incidental and consequential damages, less expenses saved (UCC § 2-712).

- *Example:* Bunker may purchase substitute Bruegel prints from another seller. If cover costs exceed Howard's contract price,

Bunker may recover the difference.

Sue for Damages for Nondelivery

If the buyer does not cover, he may still sue for nondelivery (UCC § 2-713). Damages equal the difference between the **market price** at the time the buyer learned of the breach and the contract price.

- *Example:* If Howard's prints were contracted at $100 but the market price on breach day was $125, Bunker may recover $25 × 75 prints = $1,875. If the original painting, contracted at $10,000, had a market value of $15,000 at breach, Bunker could recover an additional $5,000.

Recover the Goods (Specific Performance and Replevin)

For **unique goods** (such as the original Bruegel painting), the buyer is entitled to **specific performance**—court-ordered delivery (UCC § 2-716(1)). This extends beyond traditional common law and applies in "other proper circumstances," such as output or requirements contracts.

For identified goods not delivered, the buyer may also seek **replevin** if, after good-faith effort, cover is unavailable.

- *Example:* If Howard withholds the 25 prints already completed and identified, Bunker may bring an action for replevin to recover them.

Buyer's Remedies on Seller's Insolvency

If the seller becomes insolvent within 10 days of receiving payment, the buyer may recover goods already paid for (UCC § 2-502). In our scenario, if Howard were insolvent shortly after Bunker's first installment, Bunker could reclaim both the prints and the painting, provided he tenders any unpaid balance.

Buyer's Security Interest

If the buyer rightfully rejects or revokes acceptance, he has a **security interest** in goods already in his possession (UCC §§ 2-711(3), 2-706). The buyer may retain or resell them to recover amounts paid and reasonable expenses.

- *Example:* If Bunker holds 25 prints and Howard refuses reimbursement, Bunker may resell those prints and apply the proceeds against his claim.

Remedies When Goods Are Accepted

When nonconforming goods are accepted (or revocation is unavailable), the buyer may still recover damages if he seasonably notifies the seller of the breach (UCC §§ 2-714, 2A-519).

Compensatory Damages

Damages cover any loss resulting from the nonconformity.

- *Example:* If Howard's prints used inferior paper that deteriorated weeks later, Bunker may recover for the reduced value.

Consequential Damages

Consequential damages (UCC §§ 2-714(3), 2-715) include losses stemming from needs or requirements that the seller had reason to know.

- *Example:* If Howard used inferior ink that faded quickly, causing Bunker to lose resale contracts, Bunker may recover lost profits.

- *Case Illustration: De La Hoya v. Slim's Gun Shop* (Cal. App. 1978): Buyer of a stolen handgun recovered attorney's fees as consequential damages because the arrest for stolen property was foreseeable.

Incidental Damages

Incidental damages (UCC § 2-715) include reasonable expenses incurred due to breach, such as inspection, storage, transportation, or commissions for cover.

- *Example:* Bunker may recover the costs of storing rejected prints or arranging a substitute shipment.

Key Distinction

- **Goods Not Received:** Remedies emphasize **cancellation, cover, recovery of goods, and damages for nondelivery.**
- **Goods Accepted:** Remedies focus on **damages, both direct and consequential, plus incidental expenses.**

KEY TAKEAWAY

Parties to a sales contract may shape their own remedies in case of breach. They may limit or exclude remedies, but the **UCC requires that some meaningful remedy remain available**. If liquidated damages are specified, they must be reasonable; an unreasonably large amount is void as a penalty.

If the contract is silent, the **UCC provides default remedies**:

- **Seller's Remedies**
  - **Contract:** Cancel the contract.
  - **Goods:** Withhold or stop delivery, identify goods to the contract, or reclaim goods if the buyer is insolvent.
  - **Money:** Resell and recover damages, recover lost profits, or—in proper cases—recover the full price.
  - **Cumulative:** Unless inconsistent, these remedies may be used together. The goal is to put the nonbreaching seller in as good a position as if the contract had been performed.
- **Buyer's Remedies**
  - **Contract:** Cancel the contract.
  - **Goods:** Claim a security interest in rejected goods, recover identified goods if the seller is insolvent, or seek replevin or specific performance.
  - **Money:** Recover payments already made, "cover" by buying substitutes and recover damages, or claim damages for nondelivery.
  - **If goods are accepted:** Recover damages for breach of warranty, including incidental and consequential damages.
  - **Cumulative:** These remedies, too, may be pursued together unless mutually exclusive.

The **UCC Article on Leases (2A §§ 520–523)** provides comparable remedies for lessors and lessees.

Bottom Line: The UCC remedies—whether for seller or buyer—are designed to be flexible, cumulative, and compensatory, aiming to place the injured party in the position they would have occupied had the contract been properly performed.

EXERCISES

1. What are the four things a breaching seller could do to cause the buyer grief, commercially speaking?
2. If the buyer breaches, what rights does the seller have in regard to the goods?
3. In regard to the money owed to her?
4. In regard to the continued existence of the contract?
5. What are the four things a breaching buyer could do to cause the seller grief, commercially speaking?
6. If the seller breaches, what rights does the buyer have in regard to the goods?
7. In regard to the money owed to him?
8. In regard to the continued existence of the contract?

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18.4: Excuses for Nonperformance

LEARNING OBJECTIVES

1. Recognize how parties are discharged if the goods are destroyed.
2. Determine what defenses are valid when it becomes very difficult or impossible to perform.
3. Understand the UCC's position on the right to adequate assurances and anticipatory repudiation.

In contracts for the sale of goods, as in common law, things can go wrong. What then?

Casualty to Identified Goods

Parties are free to agree in advance on what happens if goods are destroyed before delivery. The **UCC provides a default rule** in **§§ 2-613 and 2A-221(a)**:

- If the contract requires goods **identified at the time the contract is made**, and those goods are destroyed **without fault** of either party before risk of loss passes to the buyer, then:
  - **Total loss:** The contract is avoided, and both parties are discharged.
  - **Partial loss:** The buyer may accept the goods at a reduced price, with an allowance for the defect.

Example: If Howard ships the original Bruegel to Bunker but the painting is destroyed en route (without either party's fault), the contract is discharged. If only the frame is damaged, Bunker may still accept the painting at a discount.

The UCC's Approach to "Impossibility"

The common law recognizes the doctrine of **impossibility** (see Chapter 15, *Discharge of Obligations*). The UCC broadens this concept into **commercial impracticability**.

Impracticability and Substitutions

- **§ 2-614(1), § 2A-404(1):** If normal berthing, loading, or delivery facilities become unavailable, reasonable substitutes must be used.
- If agreed transportation becomes impracticable, the seller must use a commercially reasonable substitute.
  - *Example:* If Howard contracted to deliver the prints by rail but a key bridge collapses, delivery by truck is required.

Contingencies

- **§ 2-615, § 2A-405(b):** A seller is excused if performance becomes impracticable due to a contingency the nonoccurrence of which was a **basic assumption** of the contract, or due to compliance with a government regulation (even if the regulation is later found invalid).

CISG Comparison: Article 79 excuses performance if failure was due to an impediment beyond the party's control, which could not reasonably have been foreseen or overcome at the time of contracting.

Right to Adequate Assurances of Performance

Contracts depend not only on actual performance but also on a **sense of security** that performance will be forthcoming.

- **§ 2-609, Comment 1:** If a party has **reasonable grounds for insecurity**, they may demand adequate assurance in writing. Until assurance is received, the party may suspend their own performance.
- If no assurance is given, the aggrieved party may treat this as a repudiation.

Example: If Howard suspects Bunker will not pay upon delivery, Howard may demand written assurance. If Bunker does not provide it, Howard may treat the contract as repudiated and invoke remedies.

CISG Comparison: Article 71 allows a party to suspend performance if it becomes apparent the other will not perform a substantial part of the contract, provided immediate notice is given. Performance must resume if assurance is later provided.

Anticipatory Repudiation

A party may repudiate **before performance is due**.

- **§§ 2-610 and 2A-402:** The aggrieved party may either:
  - Wait for performance, or
  - Resort immediately to remedies for breach.
- **§§ 2-611 and 2A-403:** The repudiating party may retract repudiation, unless the aggrieved party has cancelled or materially changed position in reliance.

Example: If Bunker writes to Howard refusing to pay before the delivery date, Howard may either wait or immediately sue for breach. If Bunker later retracts, Howard must accept unless he has already cancelled or relied on the repudiation.

CISG Comparison: Article 72 allows avoidance if it is clear, before the performance date, that one party will commit a fundamental breach.

Key Point: The UCC and CISG both recognize that unforeseen events, insecurity, and early repudiation may excuse or suspend performance. But the standards are strict: excuses apply only when nonperformance is beyond the party's control or when the other side gives reason to doubt future performance.

KEY TAKEAWAY

If, through no fault of either party, the goods are destroyed before the risk of loss has passed from the seller to the buyer, the parties are both discharged. If the expected means of performance is impossible, but an alternative is available, the alternative must be utilized. If performance becomes impracticable because of an unexpected contingency, failure to deliver the goods is excused. But a party who has concerns whether the other side will perform is entitled to adequate assurances of performance; if they are not forthcoming, the worried party may suspend performance. Where a party repudiates a contract before performance is due, the other side may sue immediately (anticipatory repudiation) or may wait until the time performance comes due and then sue.

EXERCISES

1. Suppose Plaintiff sues Defendant for breach of contract, and Defendant successfully raises an excuse for nonperformance. What liability does Defendant have now?
2. The contract read that the goods would be "shipped F.O.B. Seattle, by Burlington Northern Rail to the buyer in Vancouver, B.C." Due to heavy rain and mudslides, the rail line between Seattle and points north was impassable. Buyer insists Seller is obligated to send the goods by motor truck; Seller insists her performance has become impossible or at least that shipment must await the rail-line clearance. Who is correct? Explain.
3. Buyer manufactured ceramic insulators and ordered the dies into which the liquid ceramic would be poured for hardening and finishing from Seller, to be delivered April 15. The first test batch of a dozen dies arrived on February 15; these dies were defective. Buyer wrote inquiring whether the defects could be remedied in time for the final delivery. Seller responded, "We are working to address the problems here." Buyer again inquired; Seller responded, "As I said, we are working on the problems." Buyer fretted that the deadline—two months in the future—would not be met. What remedy, if any, does Buyer have now?

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18.5: Cases

Limitations of Remedy Results in No Remedy

Hartzell v. Justus Co., Inc.

693 F.2d 770 (8th Cir. S.D. 1982)

Arnold, J.

This is a diversity case arising out of the purchase by Dr. Allan Hartzell of Sioux Falls, South Dakota, of a log home construction kit manufactured by the defendant Justus Homes. Dr. Hartzell purchased the package in 1977 for $38,622 [about $135,000 in 2010 dollars] from Del Carter, who was Justus Homes' dealer for the Sioux Falls area. He also hired Carter's construction company, Natural Wood Homes, to build the house. Hartzell, who testified that the home eventually cost about $150,000, was dissatisfied with the house in many respects. His chief complaints were that knotholes in the walls and ceiling leaked rain profusely, and that the home was not weather tight because flashings were not included in the roofing materials and because the timbers were not kiln-dried and therefore shrank. He also complained that an undersized support beam, which eventually cracked, was included in the package. This latter defect was alleged to have resulted in cracks in the floor and inside doors that would not close. Hartzell further alleged that these structural defects were only partially remediable, and that the fair market value of the house was reduced even after all practicable repairs had been made. Alleging breach of implied and express warranties and negligence, he sought damages for this loss in value and for the cost of repairs. After a two-day trial, the jury returned a plaintiff's verdict for $34,794.67.

Justus Homes contends the District Court erred in failing to instruct the jury on a limitation-of-remedies clause contained in its contract with the plaintiff. The defendants rely on Clause 10c of the contract, which says Justus *will repair or replace defective materials*, and Clause 10d, which states that *this limited repair or replacement clause is the exclusive remedy available against Justus* [emphasis added]. These agreements, Justus asserts, are valid under the Uniform Commercial Code 2-719(1). Section 2-719(1) states:

(1) Subject to the provisions of subsections (2) and (3) of this section and of § 57A-2-718 on liquidation and limitation of damages,

(a) The agreement may provide for remedies in addition to or in substitution for those provided in this chapter and may limit or alter the measure of damages recoverable under this chapter, as by limiting the buyer's remedies to return of the goods and repayment of the price or to repair and replacement of nonconforming goods or parts; and

(b) Resort to a remedy as provided is optional unless the remedy is expressly agreed to be exclusive, in which case it is the sole remedy.

Subsection (1) of section 2-719 is qualified by subsection (2): "Where circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided in this title."...

The jury's verdict for the plaintiff in an amount almost exactly equal to the plaintiff's evidence of cost of repairs plus diminution in market value means it must have found that the structural defects were not entirely remediable. Such a finding necessarily means that the limited warranty failed of its essential purpose.

Two of our recent cases support this conclusion. In *Soo Line R.R. v. Fruehauf Corp.*, 547 F.2d 1365 (8th Cir.1977), the defendant claimed, relying on a limitation-of-remedies clause similar to the one involved here, that the plaintiff's damages should be limited to the reasonable cost of repairing the railroad cars that plaintiff had bought from defendant. The jury verdict included, among other things, an award for the difference between the value of the cars as actually manufactured, and what they would have been worth if they had measured up to the defendant's representations. This Court affirmed the verdict for the larger amount. We held, construing the Minnesota U.C.C., which is identical to § 2-719 as adopted in South Dakota, that the limitation-of-remedies clause was ineffective because the remedy as thus limited failed of its essential purpose. The defendant, though called upon to make the necessary repairs, had refused to do so, and the repairs as performed by the plaintiff itself "did not fully restore the cars to totally acceptable operating conditions."

Here, Justus Homes attempted to help with the necessary repairs, which is more than Fruehauf did in the *Soo Line* case, but after the repairs had been completed the house was still, according to the jury verdict, not what Justus had promised it would be. The

purpose of a remedy is to give to a buyer what the seller promised him—that is, a house that did not leak. If repairs alone do not achieve that end, then to limit the buyer's remedy to repair would cause that remedy to fail of its essential purpose....

An analogous case is *Select Pork, Inc. v. Babcock Swine, Inc.* [Citation], applying § 2-719 as adopted in Iowa. The defendant had promised to deliver to plaintiff certain extraordinary pigs known as Midwestern Gilts and Meatline Boars. Instead, only ordinary pigs were delivered. Plaintiff sued for breach of warranty, and defendant claimed that its damages, if any, should be limited to a return of the purchase price by an express clause to that effect in the contract. The District Court held that the clause was unenforceable because it was unconscionable, see § 2-719(3), and because it failed of its essential purpose. We affirmed,..."Having failed to deliver the highly-touted special pigs, defendants may not now assert a favorable clause to limit their liability." So here, where the house sold was found by the jury to fall short of the seller's promises, and where repairs could not make it right, defendant's liability cannot be limited to the cost of repairs. If the repairs had been adequate to restore the house to its promised condition, and if Dr. Hartzell had claimed additional consequential damages, for example, water damage to a rug from the leaky roof, the limitation-of-remedies clause would have been effective. But that is not this case.

There was no double recovery here: the verdict was not for cost of repair plus the entire decrease in market value, but rather for cost of repair plus the decrease in market value that still existed after all the repairs had been completed.

[T]he evidence in the record all demonstrate[s] that the repair or replacement clause was a failure under the circumstances of this case. Some of the house's many problems simply could not be remedied by repair or replacement. The clause having failed of its essential purpose, that is, effective enjoyment of implied and express warranties, the plaintiff was entitled, under UCC § 2-719(2), to any of the buyer's remedies provided by the Code. Among these remedies are consequential damages as provided in §§ 2-714 and 2-715(2)....

The judgment is affirmed.

CASE QUESTIONS

1. What did the seller here limit itself to do in case of defects? What was the limitation of remedy?
2. Did Justus Homes disclaim implied and expressed warranties with its contract language regarding limitation of remedies?
3. Was the essential purpose of the limitation of remedy to protect the party benefiting from it—here, the seller of the log home kit—or was the essential purpose of the limitation of remedy, as the court said, "effective enjoyment of implied and expressed warranties"?
4. In a part of the opinion excised, the court wrote, "A finding of unconscionability is, as a matter of logic, simply unnecessary in cases where § 2-719(2) applies." Would it be easier simply to say that the limitation of liability here was unconscionable?

Cure for Improper Delivery

Wilson v. Scampoli

228 A.2d 848 (D.C. App. 1967)

Myers, J.

This is an appeal from an order of the trial court granting rescission of a sales contract for a color television set and directing the return of the purchase price plus interest and costs.

Appellee [Mrs. Kolley's father] purchased the set in question on November 4, 1965, paying the total purchase price in cash. The transaction was evidenced by a sales ticket showing the price paid and guaranteeing ninety days' free service and replacement of any defective tube and parts for a period of one year. Two days after purchase the set was delivered and uncrated, the antennae adjusted and the set plugged into an electrical outlet to "cook out." When the set was turned on however, it did not function properly, the picture having a reddish tinge. Appellant's delivery man advised the buyer's daughter, Mrs. Kolley, that it was not his duty to tune in or adjust the color but that a service representative would shortly call at her house for that purpose. After the departure of the delivery men, Mrs. Kolley unplugged the set and did not use it.

On November 8, 1965, a service representative arrived, and after spending an hour in an effort to eliminate the red cast from the picture advised Mrs. Kolley that he would have to remove the chassis from the cabinet and take it to the shop as he could not determine the cause of the difficulty from his examination at the house. He also made a written memorandum of his service call, noting that the television '\"Needs Shop Work (Red Screen)." Mrs. Kolley refused to allow the chassis to be removed, asserting she

did not want a 'repaired' set but another 'brand new' set. Later she demanded the return of the purchase price, although retaining the set. Appellant refused to refund the purchase price, but renewed his offer to adjust, repair, or, if the set could not be made to function properly, to replace it. Ultimately, appellee instituted this suit against appellant seeking a refund of the purchase price. After a trial, the court ruled that "under the facts and circumstances the complaint is justified. Under the equity powers of the Court I will order the parties put back in their original status, let the $675 [about $4500 in 2010 dollars] be returned, and the set returned to the defendant."

Appellant does not contest the jurisdiction of the trial court to order rescission in a proper case, but contends the trial judge erred in holding that rescission here was appropriate. He argues that he was always willing to comply with the terms of the sale either by correcting the malfunction by minor repairs or, in the event the set could not be made thereby properly operative, by replacement; that as he was denied the opportunity to try to correct the difficulty, he did not breach the contract of sale or any warranty thereunder, expressed or implied.

[The District of Columbia UCC 2-508] provides:

(1) Where any tender or delivery by the seller is rejected because non-conforming and the time for performance has not yet expired, the seller may seasonably notify the buyer of his intention to cure and may then within the contract time make a conforming delivery.

(2) Where the buyer rejects a nonconforming tender which the seller had reasonable grounds to believe would be acceptable with or without money allowance the seller may if he seasonably notifies the buyer have a further reasonable time to substitute a conforming tender.

...

Removal of a television chassis for a short period of time in order to determine the cause of color malfunction and ascertain the extent of adjustment or correction needed to effect full operational efficiency presents no great inconvenience to the buyer. In the instant case, appellant's expert witness testified that this was not infrequently necessary with new televisions. Should the set be defective in workmanship or parts, the loss would be upon the manufacturer who warranted it free from mechanical defect. Here the adamant refusal of Mrs. Kolley, acting on behalf of appellee, to allow inspection essential to the determination of the cause of the excessive red tinge to the picture defeated any effort by the seller to provide timely repair or even replacement of the set if the difficulty could not be corrected. The cause of the defect might have been minor and easily adjusted or it may have been substantial and required replacement by another new set—but the seller was never given an adequate opportunity to make a determination.

We do not hold that appellant has no liability to appellee, but as he was denied access and a reasonable opportunity to repair, appellee has not shown a breach of warranty entitling him either to a brand new set or to rescission. We therefore reverse the judgment of the trial court granting rescission and directing the return of the purchase price of the set.

Reversed.

CASE QUESTIONS

1. Why did the seller "have reasonable grounds to believe [the television] would be acceptable"?
2. What did Mrs. Kolley want?
3. Does this case require a buyer to accept patchwork goods or substantially repaired articles in lieu of flawless merchandise?

Seller's Remedies When Buyer Defaults

Santos v. DeBellis

901 N.Y.S.2d 457 (N.Y. Sup.App. 2010)

Molia, J.

On March 1, 2008 and March 11, 2008, plaintiff made payments to defendant of $3,000 each, in connection with the purchase of a mobile home located in Fort Pierce, Florida. Thereafter, on March 13, 2008, plaintiff and defendant signed an agreement which had been prepared by defendant. The agreement described the subject property by its location, recorded the fact that plaintiff

had paid defendant deposits totaling $6,000, set forth a closing date of March 25, 2008, and specified that "the remaining $27,000.00" was payable at closing to defendant by a guaranteed financial instrument. Plaintiff never paid the outstanding balance and brought this action to recover the $6,000 deposit she paid to defendant. Following a nonjury trial, judgment was awarded in favor of defendant dismissing the complaint.

Because the sale of a mobile home constitutes a contract for the sale of goods rather than of real property [Citations], the parties' agreement was governed by the Uniform Commercial Code. The agreement, which was made after plaintiff had made the two $3,000 "deposit" payments, constituted a memorandum in confirmation of an oral agreement and, even though it omitted some terms, was sufficient to satisfy the statute of frauds [Citations].

Section 2-718 of the Uniform Commercial Code specifies that in the absence of a contractual provision with respect to the liquidation or limitation of damages and the return of deposits,

(2) Where the seller justifiably withholds delivery of goods because of the buyer's breach, the buyer is entitled to restitution of any amount by which the sum of his payments exceeds...

(b) [in the absence of contractually fixed terms] twenty per cent of the value of the total performance for which the buyer is obligated under the contract or $500, whichever is smaller.

(3) The buyer's right to restitution under subsection (2) is subject to offset to the extent that the seller establishes

(a) a right to recover damages under the provisions of this Article other than subsection (1), and

(b) the amount or value of any benefits received by the buyer directly or indirectly by reason of the contract.

Here, notwithstanding the fact that plaintiff, as buyer, had breached the contract, defendant failed to demonstrate any damages resulting therefrom; nor did defendant establish that plaintiff had received any benefits directly or indirectly by reason of the parties' agreement (*see* UCC 2-718[3]). Therefore, pursuant to UCC 2-718(2), plaintiff was entitled to the return of all but $500 of her deposit.

The order of the District Court dismissing the complaint is accordingly reversed, and judgment is awarded to plaintiff in the principal sum of $5,500.

CASE QUESTIONS

1. If the plaintiff had been a dealer in mobile homes and the unit here had been part of his inventory, he would be entitled to claim lost profits on the sale of one unit. Here, apparently, the plaintiff seller was a private party. Why was he not entitled to any damages greater than $500?
2. New York adopted the UCC in 1964. Five hundred dollars in 1964 would be worth about $3,500 in 2010. Why isn't the change in the dollar's value recognized here?

Buyer's Remedies When Seller Breaches

[Note: this case is slightly edited by the authors.]

Furlong v. Alpha Chi Omega Sorority

657 N.E.2d 866 (Ohio Mun. 1993)

Bachman, J.

In late September through mid-October 1992, plaintiff Johnathan James Furlong ("Furlong") contacted defendant Alpha Chi Omega Sorority ("AXO"), by phoning the chairperson of its social committee, Emily Lieberman ("Emily"), between a dozen and a dozen and a half times.

Ultimately (about the first week in October), Furlong received Emily's order for one hundred sixty-eight imprinted sweaters at $21.50 each (plus one free sweater) for delivery on Friday, October 23, 1992, so as to arrive in time for AXO's Midnight Masquerade III on the evening of Saturday, October 24, 1992.

The price was to be $3,612, [about $5600 in 2010 dollars] payable as follows: $2,000 down payment when the contract was made, and $1,612 balance when the sweaters were delivered.

An oral contract for the sale of goods (the imprinted sweaters) was made between Furlong and AXO, at a definite price and with specified dates for payment and for delivery.

At some point in those phone calls with Furlong, Emily said that the sweaters were to be custom designed with the following specified design: namely, with three colors (hunter green letters on top of maroon letters outlined in navy blue, and hunter green masks). Furlong promised to have them so imprinted (by a third party whom he would select)....Thereafter, he delivered to Emily an Ohio Wesleyan sweater with maroon letters to show her the maroon color....Additionally, he faxed to Emily a two-page description of the sweaters, which not only included the designs for the fronts and the backs of the sweaters, but also included arrows showing where each of the three colors would go (hunter green letters on top of maroon letters outlined in navy blue, and hunter green masks).

Furlong and Emily created an express warranty by each of the above three statutory means: namely, by affirmation of fact (his initial phone calls); by sample (the maroon sweater) by description (the fax).This express warranty became part of the contract. Each of the three methods of showing the express warranty was not in conflict with the other two methods, and thus they are consistent and cumulative, and constitute the warranty. [2-317]

The design was a “dickered” aspect of the individual bargain and went clearly to the essence of that. Thus, the express warranty was that the sweaters would be in accordance with the above design (including types of colors for the letters and the mask, and the number of colors for the same). Further, the express warranty became part of the contract.

On October 13, 1992, AXO mailed Furlong a $2,000 check for the down payment; he deposited it in his bank account on October 16, 1992. Thereafter, as discussed below, Furlong had the sweaters imprinted (on Thursday, October 22) and delivered to AXO (on Friday, October 23). Upon receipt of the delivery, AXO gave a check to Furlong’s agent in the amount of $1,612 for the balance of the purchase price. However, later on that day, AXO inspected the sweaters, discovered the design changes (mentioned below), caused AXO’s bank to stop payment on the check, and stated AXO’s objections in a phone call with Furlong. AXO has never paid Furlong that balance on the purchase price.

Furlong’s obligation as the seller was to transfer and deliver the goods in accordance with the contract. AXO’s obligation was to accept and pay in accordance with that contract. [2-301] We will now discuss whether it legally did so.

Furlong was a jobber for Argento Bros., Inc. (“Argento”) and had Argento print the sweaters. In doing so, Furlong worked with Argento’s artists. Early in the morning of Thursday (October 22, 1992), the artist(s) began to prepare the art work and recommended changes to the design. Furlong authorized the artist(s) to change the design without the knowledge or consent of AXO. Argento spent about eight hours printing the sweaters all day Thursday. Furlong did not phone AXO about the changes until the next day, Friday (October 23), after the sweaters were printed with those changes. Here are the five design changes that he made:

- The *first change* was to delete the agreed-upon outline for the letters (namely, the navy blue outline).
- The *second change* was to reduce the agreed-upon number of colors for the fronts and the backs (from three colors per side to two colors per side).
- The *third change* was to alter one of the agreed-upon colors (from maroon to red).
- The *fourth change* was to alter the agreed-upon scheme of colors for the letters on the fronts and the backs (namely, both sides were to have the same two colors of maroon and hunter green; whereas in fact the backs had neither of those colors, and instead had a navy blue color for the letters).
- The *fifth change* was to alter the agreed-upon color of the masks (from hunter green to maroon—actually red).

The court specifically finds that the color was *red* (actually, scarlet) and was *not maroon* (like the maroon-colored letters on the Ohio Wesleyan sweater).

The sweaters did not conform to the contract (specifically, the express warranty in the contract). Thus (in the words of the statute), the sweaters did “fail in any respect to conform to the contract.” Actually, the sweaters failed in at least five respects. [2-601] Further, not only did they “fail in any respect,” they failed in a substantial respect. In either event, they were a nonconforming tender of goods. [2-601]

On Friday morning (October 23), Furlong picked up the five to six boxes of sweaters from Argento and had a friend deliver them from Columbus to Bowling Green. The boxes arrived at the AXO house around midday. Sometime thereafter on the same day,

Emily inspected one of them and screamed her dismay upon discovering that the sweaters were not what AXO had ordered.

The court rejects Furlong's assertion that he did all that he could do under the circumstances. The obvious answer is that he did not do enough. He should have gotten AXO's prior consent to the changes. He could have done this by providing for more lead time-between the time that Argento prepared the art work and the time that it printed the sweaters. Instead, he had both done at the same time (Thursday morning).

Finally, and alternatively, plaintiff should have entered into a contract that gave him discretion to make design changes without AXO's consent. We must remember that "these sweaters," as Furlong himself admits (and describes), were to be "custom-designed" for AXO. Thus, they were to be printed according to AXO's specifications, and not according to Furlong's discretion.

Next, Furlong asserts that AXO—after learning of the changes—should have agreed to his offer of compromise: namely, that he would reduce the unit price of the sweaters in exchange for AXO's keeping them and paying the reduced price. Also, Furlong asserts that AXO should have communicated his compromise offer to AXO's members and pledges. In both respects, the court disagrees: Although the law allowed AXO to do so, it did not require AXO to do. Instead, AXO did exactly what the law allowed: AXO rejected the nconforming goods in whole.

About 4:00 p.m. on the same day that the sweaters arrived at the AXO house (Friday, October 23), Amy—as the AXO president—phoned Furlong. She said that the sweaters were not what AXO had ordered. She stated the specifics as to why the sweaters were not as ordered. She offered to return the sweaters to him, but he said "No." AXO still has possession or custody of the boxes of sweaters.

[The UCC] provides: "Rejection of goods must be within a reasonable time after their delivery * * *. It is ineffective unless the buyer seasonably notifies the seller." [2-602] AXO did what this statute requires.

That statute further provides: "[I]f the buyer has before rejection taken physical possession of goods * * *, he is under a duty after rejection to hold them with reasonable care at the seller's disposition for a time sufficient to permit the seller to remove them[.]" [2-602(2)(b)] AXO has done this, too. From the above, it is seen that AXO legally rejected the sweaters on the same day that AXO received physical possession of them.

The court disagrees with Furlong's assertion that AXO accepted the sweaters. He is confusing a layman's understanding of the term *accept* ("to receive a thing [with a consenting mind])," Webster's Collegiate Dictionary (5 Ed.1947), at 6, with the statutory meaning of the term. The mere fact that AXO took physical possession of the sweaters does not, by itself, mean that AXO legally "accepted" them.

In regard to...seller's remedies, Furlong has no legal remedies because AXO did not breach the contract. Thus, he is not entitled to an award for the $1,612 balance that he claims is due on the contract price.

As concluded above, AXO rightfully rejected the sweaters, after having paid part of the purchase price: namely, $2,000. AXO is entitled to cancel the contract and to recover the partial payment of the purchase price. [2-606]

Also, as concluded above, AXO still has rightful possession or control of the sweaters. AXO has a security interest in the sweaters in its possession or control for the part payment made on the purchase price—but when reimbursed for that part payment AXO must return the sweaters to Furlong.

The court will prepare, file, and serve a judgment entry as follows: dismissing with prejudice Furlong's claim against all defendants; dismissing with prejudice Emily Lieberman's and Amy Altomondo's counterclaims against Furlong; granting AXO's counterclaim (for $2,000, plus ten percent per annum postjudgment interest and costs).

Further, that entry will order AXO's attorney (Mr. Reddin) to retain possession of the sweaters either until further court order or until AXO's judgment is satisfied in full (whereupon he shall surrender the sweaters to Furlong if Furlong picks them up within thirty days thereafter, or, if Furlong does not, he may then dispose of them as abandoned property without any liability).

Judgment accordingly.

CASE QUESTIONS

1. Surely the plaintiff could not have thought that the radically altered design would be acceptable for the young women's masquerade ball. On what basis did he think he would be entitled to the full payment contracted for?

2. Whether Amy Altomondo knew it or not, she did what the UCC says a buyer should do when nonconforming goods are delivered. What are those steps?
3. What does it mean that AXO has a security interest in the sweaters? Security for what?

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18.6: Summary and Exercises

Summary

As with most of the Uniform Commercial Code (UCC), the parties may specify the terms of their performance. Only if they fail to do so does Article 2 (and 2A) provide the terms for them. The seller's duty is to make a timely delivery of conforming goods. In the absence of agreement, the time for delivery is a reasonable one, and the place of delivery is the seller's place of business. All goods must be tendered in a single delivery, unless circumstances permit either party the right to make or demand delivery in lots.

If the seller ships nonconforming goods but has time to meet his contractual obligations or if he reasonably believed the goods would be suitable, he may notify the buyer of his intention to cure, and if he does so in a timely manner the buyer must pay.

The buyer's general obligation is to inspect, accept, and pay. If an inspection reveals that the goods are nonconforming, the buyer may reject them; if he has accepted because defects were latent or because he received assurances that the defects would be cured, and they are not, the buyer may revoke his acceptance. He then has some duties concerning the goods in his possession. The buyer must pay for any conforming goods; payment may be in any manner consistent with current business customs. Payment is due at the time and place at which the buyer will ultimately receive the goods.

The general policy of the UCC is to put an aggrieved party in as good a position as she would have been had the other party fully performed. The parties may specify or limit certain remedies, but they may not eliminate all remedies for a breach. However, if circumstances make an agreed-on remedy inadequate, then the UCC's other remedies apply; parties may not unconscionably limit consequential damages; they may agree to liquidated damages, but not to unreasonable penalties.

In general, the seller may pursue the following remedies: withhold further delivery, stop delivery, identify to the contract goods in her possession, resell the goods, recover damages or the price, or cancel the contract. In addition, when it becomes apparent that the buyer is insolvent, the seller may, within certain time periods, refuse to deliver the remaining goods or reclaim goods already delivered.

The buyer, in general, has remedies. For goods not yet received, she may cancel the contract; recover the price paid; cover the goods and recover damages for the difference in price; or recover the specific goods if they are unique or in "other proper circumstances." For goods received and accepted, the buyer may recover ordinary damages for losses that stem from the breach and consequential damages if the seller knew of the buyer's particular needs and the buyer could not reasonably cover.

The UCC provides some excuses for nonperformance: casualty of the goods, through no fault of either party; the nonhappening of presupposed conditions that were a basic assumption of the contract; substituted performance if the agreed-on methods of performance become impracticable; right to adequate assurances of performance when reasonable grounds for insecurity of performance arise; anticipatory repudiation and resort to any remedy, before time for performance is due, is allowed if either party indicates an unwillingness to perform.

EXERCISES

1. Anne contracted to sell one hundred cans of yellow tennis balls to Chris, with a delivery to be made by June 15.
    1. On June 8, Anne delivered one hundred cans of white tennis balls, which were rejected by Chris. What course of action would you recommend for Anne, and why?
    2. Assume Ann had delivered the one hundred cans of white balls on June 15; these were rejected by Chris. Under what circumstances might Anne be allowed additional time to perform the contract?
    3. If the contract did not specify delivery, when must Anne deliver the tennis balls?
2. 1. When Anne delivers the tennis balls, does Chris have a right to inspect them? If Chris accepts the white tennis balls, may the acceptance be revoked?
    2. Assume Chris decided she could use twenty-five cans of the white balls. Could she accept twenty-five cans and reject the rest?
    3. Suppose Anne delivered white tennis balls because a fire at her warehouse destroyed her entire stock of yellow balls. Does the fire discharge Anne's contractual duties?

4. If Chris rejected the white tennis balls and Anne refused to deliver yellow ones, may Chris recover damages? If so, how would they be calculated?

3. In 1961, Dorothy and John Wilson purchased a painting from Hammer Galleries titled *Femme Debout*. It cost $11,000 (about $78,000 in 2010 dollars) and came with this promise: "The authenticity of this picture is guaranteed." In 1984, an expert deemed the painting a fake. The district court held that the Wilsons' suit for breach of warranty, filed in February 1987—twenty-one years after its purchase—was barred by the UCC's four-year statute of limitations. The Wilsons argued, however, that the Code's exception to the four-year rule applied:Uniform Commercial Code, Section 2-725(2). "A breach of warranty occurs when tender of delivery is made, except where a warranty explicitly extends to future performance and discovery must await the time of such performance the cause of action accrues when the breach is or should have been discovered."

   They said the painting "performed" by being an authentic Vuillard—a French artist—and that the warranty of authenticity not only guaranteed the present "being" of the painting but also extended, as required by 2-725(2), to the future existence as a Vuillard. Therefore, they contended, explicit words warranting future performance would be superfluous: a warranty that promises authenticity "now and at all times in the future" would be redundant. How should the court rule?

4. Speedi Lubrication Centers Inc. and Atlas Match Corp. entered into a contract that provided for Speedi to buy 400,000 advertising matchbooks from Atlas, to be paid for within thirty days of delivery of each shipment. Orders for such matches required artwork, artists' commissions, and printing plates. Atlas sent twenty-two cases of matches to Speedi with an invoice showing $2,100 owed. Almost ninety days later, Speedi sent Atlas a check for $1,000, received the same day Atlas sent Speedi a letter declaring Speedi to be in material breach of the contract. A second check for $1,100 was later received; it bounced but was later replaced by a cashier's check. The contract provided that an untimely payment was a breach, and it included these provisions related to liquidated damages:

   Atlas shall have the right to recover from Purchaser the price of all matchbooks and packaging delivered and/or identified to this agreement at the time of Purchaser's breach hereof and shall be additionally entitled to recover fifty percent (50%) of the contract price of matchbooks and/or packaging ordered hereby, but not delivered or identified to this Agreement at the time of Purchaser's breach. Purchaser agrees that the percentage as specified hereinabove...will be reasonable and just compensation for such breach, and Purchaser hereby promises to pay such sum as liquidated damages, not as penalty in the event of any such breach.

   On appeal, Speedi complained that the liquidated damages clause was a penalty. Is the matter settled by the contract saying the liquidated damages are reasonable? On what criteria would a court determine whether liquidated damages are reasonable?

5. Mrs. Kaiden made a $5,000 deposit on the purchase of new 1973 Rolls-Royce automobile. Lee Oldsmobile, the seller, confirmed the request by transmitting a regular order form, which Mrs. Kaiden signed and returned. The price was $29,500.00 [about $150,000 in 2010 dollars]. Some of the correspondence and a notation on Mrs. Kaiden's check indicated that delivery was expected in November. The order form, however, specified no delivery date. Further, it contained a disclaimer of liability for delay in delivery beyond the dealer's control, and it provided that the dealer had the right, upon failure of the purchaser to accept delivery, to retain as liquidated damages any cash deposit made. On November 21, 1973, Mrs. Kaiden notified Lee by telephone that she had purchased another Rolls-Royce elsewhere. She told the salesman to cancel her order. On November 29, Lee Oldsmobile notified Mrs. Kaiden that the car was ready for delivery. She refused delivery and demanded the return of her deposit. The dealer refused. In January 1974, the dealer—without notice to the Kaidens—sold the Rolls-Royce to another purchaser for $26,495. Mrs. Kaiden sued Lee Oldsmobile for the $5,000 deposit. The dealer carefully itemized its losses on the Kaiden deal—$5080.07. On what basis did the court dismiss the liquidated damages clause? What is the consequence of the dealer's failure to give notice of the private sale under UCC, Section 2-706(3)?
6. Hemming saw an advertisement for a Cadillac convertible once owned by the famous early rock 'n' roll singer Elvis Presley. He contracted to buy it from Whitney for $350,000 and sent Whitney $10,000 as a deposit. But, after some delay, Whitney returned the $10,000 and informed Hemming that the car had been sold to another purchaser. What remedy does Hemming have?
7. Murrey manufactured and sold pool tables. He was approached by Madsen, who had an idea for a kind of electronic pool table that would light up and make sounds like a pinball machine. Madsen made a $70,000 deposit on an order for one hundred tables but then encountered difficulties and notified Murrey that he would be unable to accept delivery of the tables. Murrey broke the tables up, salvaging materials worth about $15,000 and using the rest for firewood. The evidence was that the tables, if completed by Murrey, could have been sold for $45,000 as regular pool tables. Madsen gets his deposit back less expenses incurred by Murrey. But what principle affects Murrey's measure of damages, his right to claim expenses incurred?
8. In January 1992, Joseph Perna bought an eleven-year-old Oldsmobile at a New York City police auction sale for $1,800 plus

towing fees. It had been impounded by the police for nonpayment of parking tickets. The bill of sale from the police to Perna contained this language: “subject to the terms and conditions of any and all chattel mortgages, rental agreements, liens, conditional bills of sale, and encumbrances that may be on the motor vehicle of the [its original owner].” About a year later Perna sold the car to a coworker, Elio Marino, for $1,200. Marino repaired and improved the car by replacing the radiator, a gasket, and door locks. Ten months after his father bought the car, Marino’s son was stopped by police and arrested for driving a stolen vehicle; Mario paid $600 to a lawyer to get that matter resolved, and he never got the car back from the police. Is Perna liable to Marino for the value of the car? Is Perna liable for the consequential damages—the attorney’s fees? The relevant UCC sections are 2-312(2) and 2-714.

9. William Stem bought a used BMW from Gary Braden for $6,600 on Braden’s assertion that as far as he knew the car had not been wrecked and it was in good condition. Less than a week later Stem discovered a disconnected plug; when connected the oil-sensor warning light glowed. Mechanics informed Stem that the car was made up of the front end of a 1979 BMW and the rear end of a 1975 BMW, and the front half had 100,000 more miles on it than Stem thought. Six weeks after he purchased the car, Stem wrote Braden a letter that he refused the car and intended to rescind the sale. Braden did not accept return of the car or refund the money, and Braden continued to drive it for seven months and nearly 9,000 miles before suing. He had no other car and needed to transport his child. These issues were before the Alabama Supreme Court, construing UCC, Section 2-608: did Stem’s use of the car, notwithstanding his letter of rescission, constitute such use of it as to be an acceptance? And if not, does Stem owe Braden anything for its use?
10. Donnelly ordered a leather motorcycle jacket from Leathers Inc. The jacket was specially designed according to Donnelly’s instructions: it had a unique collar, various chromed studs throughout, and buckles, and he required an unusually large size. The coat cost $6,000. Donnelly paid $1,200 as a deposit, but after production was nearly complete, he telephoned Leathers Inc. and repudiated the contract. What should Leathers do now?

SELF-TEST QUESTIONS

1. In the absence of agreement, the place of delivery is
    1. the buyer’s place of business
    2. the seller’s place of business
    3. either the buyer’s place of business or the buyer’s residence
    4. any of the above
2. The UCC’s statute of limitations is
    1. two years
    2. three years
    3. four years
    4. none of the above
3. Under the UCC, if the buyer breaches, the seller can
    1. withhold further delivery
    2. resell the goods still in the seller’s possession
    3. recover damages
    4. do all of the above
4. If the seller breaches, the buyer can generally
    1. recover the goods, even when the goods have not been identified to the contract and the seller is not insolvent
    2. purchase substitute goods and recover their cost
    3. purchase substitute goods and recover the difference between their cost and the contract price
    4. recover punitive damages
5. Following a seller’s breach, the buyer can recover the price paid
    1. if the buyer cancels the contract
    2. only for goods the buyer has accepted
    3. for all the goods the buyer was to have received, whether or not they were accepted
    4. under none of the above conditions

SELF-TEST AnswerS

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

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19: PRODUCTS LIABILITY

Learning Objectives

After reading this chapter, you should understand the following:

1. How products-liability law allocates the costs of a consumer society
2. How warranty theory works in products liability, and what its limitations are
3. How negligence theory works, and what its problems are
4. How strict liability theory works, and what its limitations are
5. What efforts are made to reform products-liability law, and why

19.1: Introduction- Why Products-Liability Law Is Important

19.2: Warranties

19.3: Negligence

19.4: Tort Reform

19.5: Cases

19.6: Summary and Exercises

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19.1: Introduction- Why Products-Liability Law Is Important

LEARNING OBJECTIVES

1. Understand why products-liability law underwent a revolution in the twentieth century.
2. Recognize that courts play a vital role in policing the free enterprise system by adjudicating how the true costs of modern consumer culture are allocated.
3. Know the names of the modern causes of action for products-liability cases.

In previous chapters, we discussed remedies generally. In this chapter, we focus specifically on remedies available when a defective product causes personal injury or other damages. Products liability describes a type of claim, not a separate theory of liability. Products liability has strong emotional overtones—ranging from the prolitigation position of consumer advocates to the conservative perspective of the manufacturers.

History of Products-Liability Law

From Caveat Emptor to Modern Regulation

Historically, the doctrine of *caveat emptor*—"let the buyer beware"—was dominant. Until the early 20th century, many products were simple, locally made, and easily inspectable: farm-grown food, homemade remedies, local crafts, etc. In that environment, a buyer generally knew what they were getting, and could confront the maker directly if something was wrong. Reputation and local community enforcement largely sufficed.

But as manufacturing scaled up, products became complex, distributed widely, and often involved hidden risks. Buyers no longer had the ability to personally inspect or assess every aspect of quality. This changing reality shifted demands for consumer protection through regulations and liability law.

Key Turning Points

- **Upton Sinclair's *The Jungle* (1906)** exposed unsanitary practices in meatpacking, shocking the public into supporting regulation. Consumer protection laws followed.
- Over time, regulatory agencies (such as the Food & Drug Administration, Consumer Product Safety Commission) and tort doctrines (negligence, strict liability, warranties) developed to ensure safety and hold makers accountable.

Recent Cases & Recalls

Here are more current examples that show how product liability continues to function, and how the legal theories apply:

1. **Walmart Ozark Trail Water-Bottle Recall (2025)**
   - ~850,000 Ozark Trail 64-oz stainless steel insulated water bottles were recalled after reports that their lids can "forcefully eject" when opened—especially after storing carbonated or perishable beverages. U.S. Consumer Product Safety Commission+2ABC7 Los Angeles+2(opens in new window)
   - Injuries included serious impact and laceration hazards; at least two people suffered **partial blindness** after being struck in the eye. Parker Waichman LLP+2KBA Attorneys+2(opens in new window)
   - Legal themes: design defect (defective lid), failure to warn (if users were not informed about pressure buildup risks), strict liability for dangerous consumer product.
2. **Drinkmate 1-Liter Carbonation Bottles Recall (2025)**
   - Approximately 111,200 bottles (106,200 in U.S., ~5,000 in Canada) recalled due to explosion risk while in use. Users reported impact, laceration, and hearing damage. U.S. Consumer Product Safety Commission+1(opens in new window)
   - The bottles were used for carbonated drinks, were sold through major retailers. The exploding risk indicates manufacturing or design defect, a product hazardous beyond normal consumer expectation.
3. **PFAS "Forever Chemicals" Litigation and Settlements**

- 3M, DuPont, and others have faced massive lawsuits for PFAS contamination of drinking water and other consumer exposures. A major multi-state settlement in New Jersey in 2025 resolved legacy PFAS claims and future claims with a large financial commitment. 3M Company+2Steptoe+2(opens in new window)
- Firefighter protective gear and other consumer or occupational products alleged to have PFAS contamination have been sued. Reuters(opens in new window)
- Legal issues here: latent harm (health effects appear only after long exposure), failure to warn, possible warranty/strict liability principles, foreseeability of damage, regulatory obligations.

Why These Examples Matter

These modern examples are useful teaching cases because they illustrate:

- **Design and manufacturing defects** (water bottle lids that eject, bottles that explode).
- **Failure to warn / information asymmetry**, especially for risks not obvious to consumers (PFAS exposure; pressure build-up).
- **Latent defects** and harm that appears over long time periods (chemical exposure).
- **Strict liability and negligence** theories in tort, but also possible warranty avenues when there are express or implied warranties of safety or fitness.
- **Damages**: not just physical injury, but also vision loss, hearing damage, health risks, public health costs.

Updated Legal Theory Framework

As before, in modern product-liability cases, typically three legal theories are asserted:

1. **Warranty (Contract)** — governed by the UCC. For example, implied warranties of merchantability, warranty of fitness, express warranties.
2. **Negligence** — failure of the manufacturer or seller to exercise reasonable care in design, manufacture, warning.
3. **Strict Liability** — liability for defective products even without proving negligence, especially appropriate for defective design or manufacturing in consumer goods.

These theories remain central. The recent examples reinforce that product liability law must continue evolving with technology, supply chains, consumer usage patterns, and regulatory standards. See Figure 19.1.

Figure 19.1 Major Products Liability Theories



KEY TAKEAWAY

As products became increasingly sophisticated and potentially dangerous in the twentieth century, and as the separation between production and consumption widened, products liability became a very important issue for both consumers and manufacturers. Millions of people every year are adversely affected by defective products, and manufacturers and sellers pay huge amounts for

products-liability insurance and damages. The law has responded with causes of action that provide a means for recovery for products-liability damages.

EXERCISES

1. How does the separation of production from consumption affect products-liability issues?
2. What other changes in production and consumption have caused the need for the development of products-liability law?
3. How can it be said that courts adjudicate the allocation of the costs of a consumer-oriented economy?

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19.2: Warranties

LEARNING OBJECTIVES

1. Recognize a UCC express warranty and how it is created.
2. Understand what is meant under the UCC by implied warranties, and know the main types of implied warranties: merchantability, fitness for a particular purpose, and title.
3. Know that there are other warranties: against infringement and as may arise from usage of the trade.
4. See that there are difficulties with warranty theory as a cause of action for products liability; a federal law has addressed some of these.

The UCC governs express warranties and various implied warranties, and for many years it was the only statutory control on the use and meanings of warranties. In 1975, after years of debate, Congress passed and President Gerald Ford signed into law the Magnuson-Moss Act, which imposes certain requirements on manufacturers and others who warrant their goods. We will examine both the UCC and the Magnuson-Moss Act.

Types of Warranties

Creation of an Express Warranty

An **express warranty** arises whenever a seller affirms that a product will perform in a particular manner. Importantly, **formal words such as "warrant" or "guarantee" are not required**. Under **UCC § 2-313**, an express warranty becomes part of the basis of the bargain if it is created by:

1. An **affirmation of fact or promise** relating to the goods,
2. A **description** of the goods, or
3. A **sample or model**.

If any of these are present, the seller warrants that the goods will conform to the affirmation, description, sample, or model.

- *Example:* A seller who states that "the use of rustproof linings in the cans will prevent discoloration and adulteration of the solution" has given an express warranty—even if he did not intend to. (*Rhodes Pharmacal Co. v. Continental Can Co.*, 219 N.E.2d 726 (Ill. 1976)).

Because an express warranty is essentially a **promise that turns out to be false**, courts often view a breach of express warranty as akin to **misrepresentation**.

Puffery versus Warranty

Not every statement made by a seller rises to the level of a warranty. Sellers often engage in **puffery**—general statements of opinion, commendation, or exaggeration about their products.

- **UCC § 2-313(2):** "An affirmation merely of the value of the goods or a statement purporting to be merely the seller's opinion or commendation of the goods does not create a warranty."
- **Key distinction:** Facts create warranties; opinions do not.

Illustrations

- A salesperson who claims a strawberry huller is "great" is probably puffing, not warranting. But if the huller destroys strawberries, the statement may still be actionable under consumer protection doctrines.
- In *Wat Henry Pontiac Co. v. Bradley* (210 P.2d 348 (Okla. 1949)), a salesperson's claim that a used car was in "A-1 shape" and "mechanically perfect" was deemed an **express warranty**. The car broke down while transporting the buyer's infant, and the court enforced the promise.

- By contrast, in *Frederickson v. Hackney* (198 N.W. 806 (Minn. 1924)), the seller of a bull calf promised it would "put the buyer on the map" and touted its father as the "greatest living dairy bull." The calf turned out to be sterile, but the court treated these remarks as **sales talk, not warranties**.

Drawing the Line

The difference between enforceable warranty and puffery often turns on:

- **Specificity and measurability**: The more precise the claim, the more likely it is a warranty.
- **Form of communication**: Written statements are more likely to be construed as warranties than oral representations.
- **Reasonableness of reliance**: Courts sometimes consider whether a buyer's reliance was reasonable, though this should not be the decisive factor. If the seller explicitly promises—even an improbable outcome, like a car getting 100 miles per gallon—the promise should be enforceable as a warranty.

CISG Comparison

The **CISG** (Article 35) adopts a similar standard:

- The seller must deliver goods that match the **quantity, quality, and description** required by the contract.
- Goods must also possess the qualities of any **sample or model** provided by the seller.

Thus, under both the UCC and CISG, **objective representations of fact, description, or model create enforceable obligations**, while mere sales puffery does not.

Implied Warranties

Express warranties are those over which the parties explicitly negotiated—or could have. They go to the **essence of the bargain.** By contrast, an **implied warranty** arises not from the parties' words but from the law itself. Courts imply warranties out of **fairness and common sense,** ensuring that basic standards of quality and honesty are met in commercial transactions.

Implied Warranty of Merchantability

Under **UCC § 2-314,** whenever a merchant sells goods, the law implies a warranty of **merchantability.** Goods are "merchantable" if they meet these minimum standards:

1. Pass without objection in the trade under the contract description.
2. In the case of fungible goods, be of fair average quality within the description.
3. Be fit for the ordinary purposes for which such goods are used.
4. Run, within permitted variations, of even kind, quality, and quantity within each unit and among all units involved.
5. Be adequately packaged and labeled as the agreement requires.
6. Conform to any promises or affirmations of fact made on the container or label.

Food cases are the classic examples. The UCC expressly provides that serving food or drink is a "sale." But what happens when someone bites into a cherry pit in cherry ice cream or finds a bone fragment in fish chowder? Courts use two tests:

- **Natural/Foreign Test:** If the substance is natural to the food (like bones in fish), the food is still merchantable.
- **Reasonable Expectations Test:** The more consumer-friendly rule, asking whether a consumer reasonably expected to find the item in the food.

The **CISG, Article 35,** echoes this rule: goods must be fit for the purposes for which goods of the same description are ordinarily used.

Implied Warranty of Fitness for a Particular Purpose

Under **UCC § 2-315,** an implied warranty arises when:

1. The seller knows the buyer's **particular purpose** for the goods, and
2. The buyer relies on the seller's **skill or judgment** in selecting suitable goods.

Example: You tell a clerk you need quick-drying paint because rain is coming. If they sell you slow-drying oil paint, the implied warranty of fitness is breached.

Contrast with merchantability: paint generally covers and protects surfaces—that's its **ordinary** purpose. But promising quick-drying performance creates a **particular purpose** warranty.

The **CISG, Article 35,** is similar: goods must be fit for any particular purpose made known to the seller, unless reliance was unreasonable.

Other Implied Warranties

- **Good Title (§ 2-312):** The seller implicitly warrants that they own the goods and can transfer them free of liens or claims. *Example: Menzel v. List (N.Y. 1969),* where a gallery sold a Chagall painting that turned out to be stolen during WWII—the gallery was liable for breach of the implied warranty of title.
- **No Infringement (§ 2-312):** A merchant warrants that goods are free of rightful claims of copyright, trademark, or patent infringement.
- **Course of Dealing/Trade Usage (§ 2-314(3)):** Customary practices may create implied warranties. For example, a dog breeder is expected to provide pedigree papers.

Problems with Warranty Theory

Even with express or implied warranties, plaintiffs face challenges:

1. **Sale Required:** Warranty law applies only to sales of goods (not services or real estate).
2. **Statute of Limitations (§ 2-725):** Four years from delivery—not discovery.
3. **Notice Requirement (§ 2-607):** Buyers must notify sellers of defects within a reasonable time.
4. **Practical Difficulties:** Few consumers understand how to preserve these rights.

Exclusion or Modification of Warranties

- **Express Warranties:** Sellers cannot use fine print to negate an express warranty already made (§ 2-316(1)).
- **Implied Warranties:** Can be excluded by "as is" or "with all faults," or by inspection opportunities.
- **Merchantability Disclaimer:** Must mention "merchantability" and be conspicuous (§ 2-316(2)).
- **Fitness Disclaimer:** Must be written, conspicuous, and broad language is sufficient (e.g., "There are no warranties beyond this contract").

Conflict Rule (§ 2-317): If warranties conflict, courts prefer to harmonize them. Where that's impossible, *express warranties generally trump implied warranties,* except for fitness, which courts favor in close cases.

Magnuson-Moss Warranty Act (1975)

Congress strengthened consumer protections by requiring clear, conspicuous warranties for household goods. Key points:

- Warranties must disclose who is covered, what's covered/excluded, duration, and steps for claims.
- Warranties must be labeled **"full"** (free repairs/replacement, reasonable time, transferable) or **"limited."**
- Outlaws **phantom warranties** (where fine print disclaimers gutted consumer rights).
- Prevents disclaimers of implied warranties when a written warranty is given (though duration may be limited).

Privity

A second problem with warranty law (after exclusion and modification of warranties) is the issue of **privity.**

Privity is the legal term for the direct contractual relationship between the seller and the buyer. For decades, courts followed the doctrine of privity strictly: only those in direct privity could sue for breach of warranty. That meant if you bought a product from a retailer, you could sue the retailer—but not the wholesaler or manufacturer—because you had no direct contractual relationship with them.

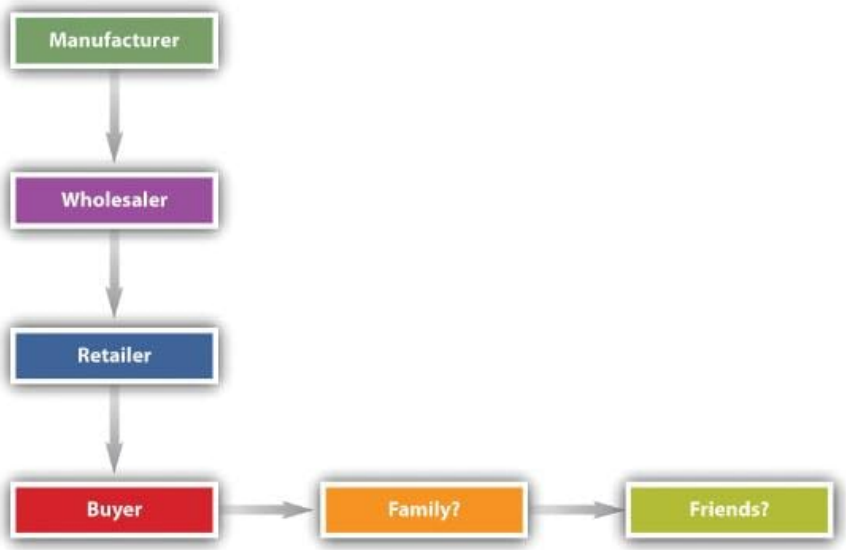
This doctrine worked reasonably well when commerce was mostly **local** and buyers dealt face-to-face with sellers. For example, a 19th-century farmer buying tools from the village blacksmith was clearly in privity with the maker of the goods.

But in today's **industrial and global economy,** products pass through complex distribution chains—manufacturers, component suppliers, wholesalers, shippers, retailers—before reaching the consumer. Figure 19.2 illustrates this modern reality.

This shift raises two important questions:

1. **Vertical Privity:** Is the manufacturer (or wholesaler) liable to the buyer under warranty theory, even if the buyer purchased only from the retailer?
2. **Horizontal Privity:** May the buyer's family members, guests, or even bystanders—who did not directly purchase the goods—assert warranty rights when injured by the product?

Figure 19.2 Chain of Distribution



Horizontal Privity

Definition:
Horizontal privity refers to the rights of **noncontracting parties**—such as family members, household members, guests, or even bystanders—to bring a warranty claim when they are injured by defective goods, even though they did not directly buy the product. It determines **to whose benefit a warranty flows** beyond the actual buyer.

Examples:

- Carl Consumer buys a lamp. The lamp is defective, and Carl suffers an electrical shock. Carl is covered because he is in direct privity with the seller.
- Carl's spouse, Carlene, is injured by the lamp. She did not purchase it, but depending on the state's horizontal privity rules, she may be covered.
- Carl's friend David, visiting as a guest, is shocked by the lamp. Again, whether he can sue under warranty depends on which approach the state follows.
- Under **Alternative A (narrowest, UCC §2-318)**: only Carlene and David (as family or household members, or guests) are covered, and only for personal injury.

- Under **Alternative B (broader, UCC §2-318)**: any natural person who could reasonably be expected to use or be affected by the lamp is covered for personal injury, such as Carl's neighbor if Carl brought the lamp next door.
- Under **Alternative C (broadest, UCC §2-318)**: coverage extends to *any person or entity*—including corporations—and applies to both personal injury and property damage.

Because states choose different alternatives, horizontal privity rules vary across jurisdictions, undermining the UCC's goal of uniformity and sometimes creating disputes about where a lawsuit can be filed.

Vertical Privity

Definition:
Vertical privity refers to the **chain of distribution**—whether a buyer can sue not just the retailer who sold the goods but also upstream parties such as the wholesaler or manufacturer. Traditionally, courts required direct contractual privity, meaning a consumer could only sue the retailer, not the manufacturer.

Examples:

- Carl buys the defective lamp from a local store. Under the old rule, Carl could sue only the store, not the lamp manufacturer.
- But suppose the lamp was defectively manufactured at the factory, and the manufacturer was best able to compensate Carl. Under modern law, many courts allow Carl to sue the manufacturer directly, even though Carl did not buy from them.
- This shift began with cases like *Spence v. Three Rivers Builders & Masonry Supply, Inc.* (Mich. 1958), where the court rejected the strict vertical privity requirement.
- Today, in most jurisdictions, consumers can bring warranty claims against manufacturers, wholesalers, and other upstream parties in the chain of distribution.

Contributory Negligence, Comparative Negligence, and Assumption of Risk

When a plaintiff sues for breach of warranty, even if issues like disclaimers and privity are resolved, defenses based on the plaintiff's own conduct may come into play. The three major defenses are:

1. Assumption of Risk

- **Definition:** The plaintiff knowingly and voluntarily encounters a known danger.
- **Rule:** Courts uniformly recognize assumption of risk as a valid defense to warranty claims.
- **Example:** A consumer buys a space heater, sees that the cord is frayed, and uses it anyway. If the heater sparks and causes a fire, the consumer may be barred from recovery because they assumed the risk by using an obviously dangerous product.

2. Contributory Negligence

- **Definition:** The plaintiff's own negligence contributed to the harm.
- **Rule:** In some jurisdictions, contributory negligence is still recognized and can completely bar recovery. But its application in warranty cases is controversial, since warranty is based on contract as much as tort.
- **Example:** A driver installs defective brake pads but also fails to maintain brake fluid levels. If an accident occurs, the seller may argue the buyer's contributory negligence was the real cause of the injury.

3. Comparative Negligence

- **Definition:** The plaintiff's recovery is reduced in proportion to their share of fault.
- **Rule:** Many courts apply comparative negligence in warranty cases, but there is no uniform approach.
- **Example:** A bicyclist is injured when a defective helmet cracks on impact. The jury finds the helmet was 70% responsible for the injury, but also finds the rider was 30% at fault for not fastening the chin strap properly. Damages would be reduced by 30%.

KEY TAKEAWAY

A first basis of recovery in products-liability theory is **breach of warranty**. Warranties fall into two categories: **express** and **implied**. Implied warranties include (1) the warranty of merchantability (available only from merchant sellers), (2) the warranty of fitness for a particular purpose, and (3) the warranty of title.

Warranty theory has important **limitations**:

- There must have been a **sale of goods**.
- The plaintiff must bring the action **within four years** of tender of delivery.
- The plaintiff must give the seller **timely notice of the breach**.
- Sellers may, within limits (e.g., the Magnuson-Moss Act), **exclude or modify warranties**.

The traditional requirement of **privity** between buyer and seller has been significantly eroded, but it may still limit some claims. Additionally, a plaintiff's own conduct—such as **assuming the risk** of using defective goods—can bar recovery.

EXERCISES

1. What are the two main types of warranties and the important subtypes?
2. Who can make each type of warranty?
3. What general problems does a plaintiff have in bringing a products-liability warranty case?
4. What problems are presented concerning exclusion or manipulative express warranties, and how does the Magnuson-Moss Act address them?
5. How are implied warranties excluded?
6. What is the problem of lack of privity, and how does modern law deal with it?

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19.3: Negligence

LEARNING OBJECTIVES

1. Recognize how the tort theory of negligence may be of use in products-liability suits.
2. Understand why negligence is often not a satisfactory cause of action in such suits: proof of it may be difficult, and there are powerful defenses to claims of negligence.

Negligence is the second major theory raised in typical products-liability cases. Unlike warranty—which arises from contract law—negligence is rooted in **tort law**. The key advantage of negligence theory is that **privity is not required**. For example, if a pedestrian is struck in an intersection by a car whose brakes were defectively manufactured, that pedestrian has no contractual relationship with the manufacturer. A warranty claim would fail for lack of privity, but a negligence claim is available because it rests on the broader duty to exercise **reasonable care**.

Negligence, discussed in greater detail in the *Introduction to Tort Law chapter,* essentially means a failure to use due care under the circumstances. In the context of products liability, negligence theory is most useful in two recurring categories: **design defects** and **inadequate warnings**.

Typical Negligence Claims: Design Defects and Inadequate Warnings

Design Defects

Manufacturers may be held liable when a product's design itself is unreasonably dangerous, even if the product was perfectly manufactured. The legal question is whether the designer used **reasonable care** in creating a product safe for its **foreseeable use**.

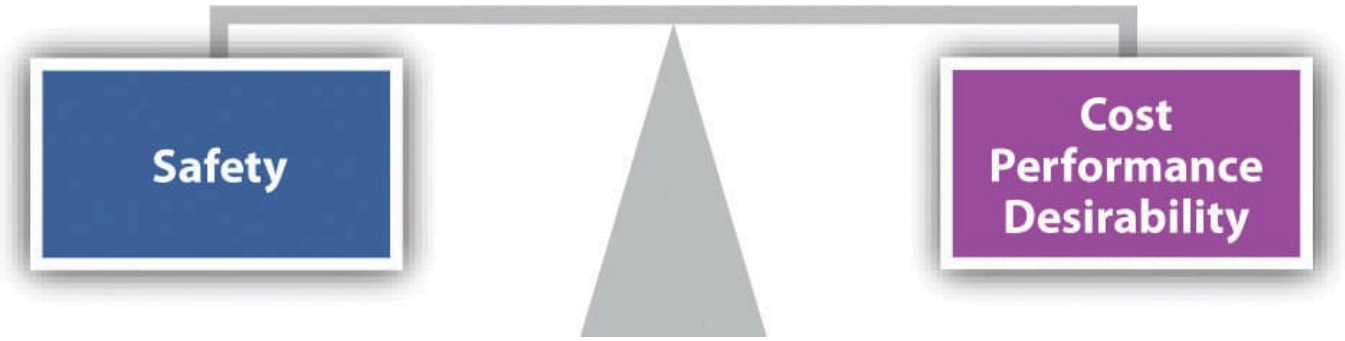
Defective-design cases are especially difficult because they require courts and juries to evaluate complex trade-offs between **safety, cost, functionality, and consumer appeal**. Adding safety features often raises production costs or reduces performance, while lowering costs can increase risks. At some point, safety must come into reasonable balance with performance and price—a balance often contested in litigation (see Figure 19.3 *The Reasonable Design Balance*).

Courts may weigh factors such as:

- Was a **safer alternative design** technologically and economically feasible at the time of manufacture?
- Did the manufacturer adequately assess the **foreseeable risks** of harm?
- Were comparable products on the market designed in a **safer manner**, making the defendant's product appear unreasonably risky?

Example: Suppose a manufacturer places a fuel tank in a location that makes it prone to rupture in minor collisions. If relocating the tank would have cost only a few dollars per vehicle but would have prevented severe injuries, a court may find the design negligent because the risks far outweighed the savings.

Figure 19.3 The Reasonable Design Balance



Warning Defects

A product may also be considered defective if the manufacturer **fails to provide adequate warnings or instructions** about its potential dangers. Even a well-designed product can be unreasonably dangerous if the user is not informed of risks that are not obvious. In such cases, liability is based not on the design itself but on the **failure to warn**—a recognized form of negligence.

The central question is **foreseeability**: would a reasonable manufacturer have foreseen the potential danger and provided a warning? If so, the failure to affix an appropriate warning label, include instructions, or otherwise alert the consumer will usually be treated as negligence.

Example: The manufacturer of a weed killer that contains poisonous ingredients acts negligently if it fails to warn consumers that the contents are potentially lethal. A reasonable consumer might assume the product kills weeds, but not realize that accidental ingestion—or even prolonged skin exposure—poses serious health risks.

The law in this area is complex, focusing on two key issues:

1. **The necessity of a warning** – Did the manufacturer have a duty to warn about this specific danger?
2. **The adequacy of the warning** – Was the warning clear, conspicuous, and understandable to an ordinary consumer?

What is considered "reasonable" depends on the likelihood of product misuse and whether the hazard is one that the consumer could be expected to recognize without instruction. For example, most people know that knives are sharp, so a manufacturer need not warn "Caution: Blade may cut." But where the danger is less obvious, a warning is required.

Problems with Negligence Theory

Negligence is one of the oldest causes of action in tort law, and as discussed in Chapter 7, it comes with a number of **defenses and limitations**. In products-liability cases, these defenses can create significant obstacles for plaintiffs. Two major categories are worth highlighting: **common-law defenses** and **federal preemption**.

Common-Law Defenses

A plaintiff who brings a negligence claim in a products-liability case faces several hurdles:

1. **Proving negligence itself.**
   A product may be defective, but that does not automatically prove the manufacturer breached its duty of care.

2. **Proximate cause.**
   Even if the manufacturer was negligent, the plaintiff must show that the injury was proximately caused by that negligence—not by some other intervening factor.

3. **Contributory or comparative negligence.**
   If the plaintiff's own actions contributed to the injury (for example, failing to follow instructions), recovery may be barred or reduced.

4. **Subsequent alteration of the product.**

Manufacturers are generally not liable if the product has been materially altered after leaving their control.

5. **Misuse or abuse of the product.**
   If a consumer uses a product in an unforeseeable and unreasonable way—such as using a lawnmower to trim a hedge or intentionally overdosing on medication—the manufacturer is unlikely to be held liable.

6. **Assumption of the risk.**
   If the plaintiff knew about the defect or danger and used the product anyway, the defense may defeat the claim.

Preemption

Another significant issue is **federal preemption.** Preemption occurs when federal law or regulations "take over" and displace state law claims, including negligence actions.

Consider this problem: suppose a federal agency sets safety standards for a particular product, and the manufacturer complies with those standards. If a consumer is injured, can the manufacturer argue that compliance with federal regulations **preempts** state negligence law? Manufacturers often claim:

> "We built the product to federal standards—therefore, we cannot be liable under state tort law."

This issue often arises in cases involving:

- Cigarettes and tobacco labeling
- FDA-approved medical devices and pharmaceuticals
- Pesticides
- Motor vehicles and safety standards
- Marine equipment, such as motor-boat propellers

Courts are divided. Sometimes they find preemption, meaning compliance with federal standards is a complete defense; other times they allow the state negligence claim to proceed, reasoning that federal standards are a **minimum floor** rather than a maximum ceiling.

KEY TAKEAWAY

Negligence is a second possible cause of action for products-liability claimants. A main advantage is that no issues of privity are relevant, but there are often problems of proof; there are a number of robust common-law defenses, and federal preemption is a recurring concern for plaintiffs' lawyers.

EXERCISES

1. What two types of products-liability cases are most often brought under negligence?
2. How could it be said that merely because a person suffers injury as the result of a defective product, proof of negligence is not necessarily made?
3. What is "preemption" and how is it used as a sword to defeat products-liability plaintiffs?

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19.4: Tort Reform

LEARNING OBJECTIVES

1. See why tort reform is advocated, why it is opposed, and what interests take each side.
2. Understand some of the significant state reforms in the last two decades.
3. Know what federal reforms have been instituted.

The Cry for Reform

In 1988, The Conference Board surveyed more than 500 chief executive officers from large and small companies about the impact of products-liability law on their firms. The study concluded that U.S. companies were at a competitive disadvantage internationally and called for significant reform. Since then, debates over products-liability reform have continued, often heatedly, with business and consumer groups sharply divided.

Business groups argue that broad liability rules drive up costs, stifle innovation, and make U.S. firms less competitive in the global marketplace. They press for tort reform as a matter of both fairness and economic survival. **Consumer advocates and trial lawyers**, in contrast, argue that businesses are simply trying to escape accountability and shift the cost of defective or unsafe products onto consumers.

The rhetoric can be harsh. Pro-business organizations deride certain states as *"judicial hellholes"* and accuse trial lawyers of orchestrating campaigns to undo years of reform. Plaintiffs' advocates counter that there is "scant evidence" of widespread abuse and that corporate lobbying aims to strip away consumer protections. What is certain is that perceptions of the "tort crisis" are often shaped by self-interest.

State Reforms

Spurred by aggressive lobbying from trade associations, nearly every state has enacted at least one reform measure in the last few decades. Some simply codify existing case law, while others significantly limit liability. The most common reforms include:

- **Statutes of Repose**
  These laws limit how long a manufacturer can be held liable for injuries caused by its products. Typically ranging from six to twelve years, a statute of repose bars claims involving older products—even if the injury occurs later. Manufacturers pushed for these laws after facing lawsuits over products decades old.

- **State-of-the-Art Defense**
  Several states have enacted statutes protecting manufacturers from liability for not using technology that was unavailable at the time of manufacture. The idea is to prevent juries from unfairly judging older designs by newer standards.

- **Failure-to-Warn Limits**
  Because failure-to-warn claims are often easier to prove than defective design claims, some states restrict their use. For example, manufacturers may not be liable if the misuse was unforeseeable.

- **Comparative Fault for Consumer Misuse**
  Many states apply comparative fault rules even in strict liability cases. If a plaintiff misused the product in a way that contributed to the injury, damages may be reduced proportionally.

- **Criminal Penalties**
  Not all reforms favor manufacturers. For example, under California's Corporate Criminal Liability Act, companies and managers must notify regulators if they know of a product defect. Failure to do so can lead to criminal charges, as Toyota executives were warned during the sudden-acceleration controversy of the early 2000s.

Federal Reform

Efforts to pass a uniform federal products-liability law have largely stalled, leaving manufacturers subject to a patchwork of state rules. However, the federal government does play a role through regulatory agencies.

In 1972, Congress created the **Consumer Product Safety Commission (CPSC)**, granting it broad authority to regulate more than 10,000 consumer products. The CPSC can issue mandatory safety standards, recall unsafe products, require hazard warnings, and recover costs on behalf of consumers. It also enforces earlier federal laws such as the Flammable Fabrics Act and the Poison Prevention Packaging Act.

The CPSC has been active in areas like bicycles, power mowers, pool slides, and extension cords. Yet its record is mixed: critics argue it lacks resources and often moves too slowly to address emerging hazards.

KEY TAKEAWAY

Business advocates claim the American tort system—products-liability law included—is broken and corrupted by grasping plaintiffs' lawyers; plaintiffs' lawyers say businesses are greedy and careless and need to be smacked into recognition of its responsibilities to be more careful. The debate rages on, decade after decade. But there have been some reforms at the state level, and at the federal level the Consumer Product Safety Act sets out standards for safe products and requires recalls for defective ones. It is regularly castigated for (1) being officious and meddling or (2) being too timid.

EXERCISES

1. Why is it so difficult to determine if there really is a "tort crisis" in the United States?
2. What reforms have been made to state tort law?
3. What federal legislation affects consumer safety?

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19.5: Cases

Implied Warranty of Merchantability and the Requirement of a “Sale”

Sheeskin v. Giant Food, Inc.

318 A.2d 874 (Md. App. 1974)

Davidson, J.

Every Friday for over two years Nathan Seigel, age 73, shopped with his wife at a Giant Food Store. This complex products liability case is before us because on one of these Fridays, 23 October 1970, Mr. Seigel was carrying a six-pack carton of Coca-Cola from a display bin at the Giant to a shopping cart when one or more of the bottles exploded. Mr. Seigel lost his footing, fell to the floor and was injured.

In the Circuit Court for Montgomery County, Mr. Seigel sued both the Giant Food, Inc., and the Washington Coca-Cola Bottling Company, Inc., for damages resulting from their alleged negligence and breach of an implied warranty. At the conclusion of the trial Judge Walter H. Moorman directed a verdict in favor of each defendant....

In an action based on breach of warranty it is necessary for the plaintiff to show the existence of the warranty, the fact that the warranty was broken and that the breach of warranty was the proximate cause of the loss sustained. [UCC] 2-314....The retailer, Giant Food, Inc., contends that appellant failed to prove that an implied warranty existed between himself and the retailer because he failed to prove that there was a sale by the retailer to him or a contract of sale between the two. The retailer maintains that there was no sale or contract of sale because at the time the bottles exploded Mr. Seigel had not yet paid for them. We do not agree.

[UCC] 2-314(1) states in pertinent part:

Unless excluded or modified, a warranty that the goods shall be merchantable is implied **in a contract for their sale** if the seller is a merchant with respect to goods of that kind.Uniform Commercial Code, Section 2-316. (emphasis added)

Thus, in order for the implied warranties of 2-314 to be applicable there must be a “contract for sale.” In Maryland it has been recognized that neither a completed ‘sale’ nor a fully executed contract for sale is required. It is enough that there be in existence an executory contract for sale....

Here, the plaintiff has the burden of showing the existence of the warranty by establishing that at the time the bottles exploded there was a contract for their sale existing between himself and the Giant. [Citation] Mr. Titus, the manager of the Giant, testified that the retailer is a “self-service” store in which “the only way a customer can buy anything is to select it himself and take it to the checkout counter.” He stated that there are occasions when a customer may select an item in the store and then change his mind and put the item back. There was no evidence to show that the retailer ever refused to sell an item to a customer once it had been selected by him or that the retailer did not consider himself bound to sell an item to the customer after the item had been selected. Finally, Mr. Titus said that an employee of Giant placed the six-pack of Coca-Cola selected by Mr. Seigel on the shelf with the purchase price already stamped upon it. Mr. Seigel testified that he picked up the six-pack with the intent to purchase it.

We think that there is sufficient evidence to show that the retailer’s act of placing the bottles upon the shelf with the price stamped upon the six-pack in which they were contained manifested an intent to offer them for sale, the terms of the offer being that it would pass title to the goods when Mr. Seigel presented them at the check-out counter and paid the stated price in cash. We also think that the evidence is sufficient to show that Mr. Seigel’s act of taking physical possession of the goods with the intent to purchase them manifested an intent to accept the offer and a promise to take them to the checkout counter and pay for them there.

[UCC] 2-206 provides in pertinent part:

(1) Unless otherwise unambiguously indicated by the language or circumstances

(a) An offer to make a contract shall be construed as inviting acceptance in any manner and by any medium reasonable in the

circumstances....

The Official Comment 1 to this section states:

Any reasonable manner of acceptance is intended to be regarded as available unless the offeror has made quite clear that it will not be acceptable.

In our view the manner by which acceptance was to be accomplished in the transaction herein involved was not indicated by either language or circumstances. The seller did not make it clear that acceptance could not be accomplished by a promise rather than an act. Thus it is equally reasonable under the terms of this specific offer that acceptance could be accomplished in any of three ways: 1) by the act of delivering the goods to the check-out counter and paying for them; 2) by the promise to pay for the goods as evidenced by their physical delivery to the check-out counter; and 3) by the promise to deliver the goods to the check-out counter and to pay for them there as evidenced by taking physical possession of the goods by their removal from the shelf.

The fact that customers, having once selected goods with the intent to purchase them, are permitted by the seller to return them to the shelves does not preclude the possibility that a selection of the goods, as evidenced by taking physical possession of them, could constitute a reasonable mode of acceptance. Section 2-106(3) provides:

"Termination" occurs when either party pursuant to a power created by agreement or law puts an end to the contract otherwise then for its breach. On "termination" all obligations which are still executory on both sides are discharged but any right based on prior breach or performance survives.

Here the evidence that the retailer permits the customer to "change his mind" indicates only an agreement between the parties to permit the consumer to end his contract with the retailer irrespective of a breach of the agreement by the retailer. It does not indicate that an agreement does not exist prior to the exercise of this option by the consumer....

Here Mr. Seigel testified that all of the circumstances surrounding his selection of the bottles were normal; that the carton in which the bottles came was not defective; that in lifting the carton from the shelf and moving it toward his basket the bottles neither touched nor were touched by anything other than his hand; that they exploded almost instantaneously after he removed them from the shelf; and that as a result of the explosion he fell injuring himself. It is obvious that Coca-Cola bottles which would break under normal handling are not fit for the ordinary use for which they were intended and that the relinquishment of physical control of such a defective bottle to a consumer constitutes a breach of warranty. Thus the evidence was sufficient to show that when the bottles left the retailer's control they did not conform to the representations of the warranty of merchantability, and that this breach of the warranty was the cause of the loss sustained....

[Judgment in favor of Giant Foods is reversed and the case remanded for a new trial. Judgment in favor of the bottler is affirmed because the plaintiff failed to prove that the bottles were defective when they were delivered to the retailer.]

CASE QUESTIONS

1. What warranty did the plaintiff complain was breached here?
2. By displaying the soda pop, the store made an offer to its customers. How did the court say such offers might be accepted?
3. Why did the court get into the discussion about "termination" of the contract?
4. What is the controlling rule of law applied in this case?

Strict Liability and Bystanders

Embs v. Pepsi-Cola Bottling Co. of Lexington, Kentucky, Inc.

528 S.W.2d 703 (Ky. 1975)

Jukowsky, J.

On the afternoon of July 25, 1970 plaintiff-appellant entered the self-service retail store operated by the defendant-appellee, Stamper's Cash Market, Inc., for the purpose of "buying soft drinks for the kids." She went to an upright soft drink cooler, removed five bottles and placed them in a carton. Unnoticed by her, a carton of Seven-Up was sitting on the floor at the edge of the produce counter about one foot from where she was standing. As she turned away from the cooler she heard an explosion that

sounded “like a shotgun.” When she looked down she saw a gash in her leg, pop on her leg, green pieces of a bottle on the floor and the Seven-Up carton in the midst of the debris. She did not kick or otherwise come into contact with the carton of Seven-Up prior to the explosion. Her son, who was with her, recognized the green pieces of glass as part of a Seven-Up bottle.

She was immediately taken to the hospital by Mrs. Stamper, a managing agent of the store. Mrs. Stamper told her that a Seven-Up bottle had exploded and that several bottles had exploded that week. Before leaving the store Mrs. Stamper instructed one of her children to clean up the mess. Apparently, all of the physical evidence went out with the trash. The location of the Seven-Up carton immediately before the explosion was not a place where such items were ordinarily kept....

When she rested her case, the defendants-appellees moved for a directed verdict in their favor. The trial court granted the motion on the grounds that the doctrine of strict product liability in tort does not extend beyond users and consumers and that the evidence was insufficient to permit an inference by a reasonably prudent man that the bottle was defective or if it was, when it became so.

In [Citation] we adopted the view of strict product liability in tort expressed in Section 402 A of the American Law Institute’s Restatement of Torts 2d.

402 A. Special Liability of Seller of Product for Physical Harm to User or Consumer

(1) One who sells any product in a defective condition unreasonably dangerous to the user or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or to his property, if

(a) the seller is engaged in the business of selling such a product, and

(b) it is expected to and does reach the user or consumer without substantial change in the condition in which it was sold.

(2) The rule stated in Subsection (1) applies although

(a) the seller has exercised all possible care in the preparation and sale of his product, and

(b) the user or consumer has not bought the product from or entered into any contractual relation with the seller.

Comment *f* on that section makes it abundantly clear that this rule applies to any person engaged in the business of supplying products for use or consumption, including any manufacturer of such a product and any wholesale or retail dealer or distributor.

Comment *c* points out that on whatever theory, the justification for the rule has been said to be that the seller, by marketing his product for use and consumption, has undertaken and assumed a special responsibility toward any member of the consuming public who may be injured by it; that the public has the right to and does expect that reputable sellers will stand behind their goods; that public policy demands that the burden of accidental injuries caused by products intended for consumption be placed upon those who market them, and be treated as a cost of production against which liability insurance can be obtained; and that the consumer of such products is entitled to the maximum of protection at the hands of someone, and the proper persons to afford it are those who market the products.

The caveat to the section provides that the Institute expresses no opinion as to whether the rule may not apply to harm to persons other than users or consumers. Comment on caveat *o* states the Institute expresses neither approval nor disapproval of expansion of the rule to permit recovery by casual bystanders and others who may come in contact with the product, and admits there may be no essential reason why such plaintiffs should not be brought within the scope of protection afforded, other than they do not have the same reasons for expecting such protection as the consumer who buys a marketed product, and that the social pressure which has been largely responsible for the development of the rule has been a consumer’s pressure, and there is not the same demand for the protection of casual strangers....

The caveat articulates the essential point: Once strict liability is accepted, bystander recovery is fait accompli.

Our expressed public policy will be furthered if we minimize the risk of personal injury and property damage by charging the costs of injuries against the manufacturer who can procure liability insurance and distribute its expense among the public as a cost of doing business; and since the risk of harm from defective products exists for mere bystanders and passersby as well as for the purchaser or user, there is no substantial reason for protecting one class of persons and not the other. The same policy requires us to maximize protection for the injured third party and promote the public interest in discouraging the marketing of products having defects that are a menace to the public by imposing strict liability upon retailers and wholesalers in the

distributive chain responsible for marketing the defective product which injures the bystander. The imposition of strict liability places no unreasonable burden upon sellers because they can adjust the cost of insurance protection among themselves in the course of their continuing business relationship.

We must not shirk from extending the rule to the manufacturer for fear that the retailer or middleman will be impaled on the sword of liability without regard to fault. Their liability was already established under Section 402 A of the Restatement of Torts 2d. As a matter of public policy the retailer or middleman as well as the manufacturer should be liable since the loss for injuries resulting from defective products should be placed on those members of the marketing chain best able to pay the loss, who can then distribute such risk among themselves by means of insurance and indemnity agreements. [Citation]...

The result which we reach does not give the bystander a "free ride." When products and consumers are considered in the aggregate, bystanders, as a class, purchase most of the same products to which they are exposed as bystanders. Thus, as a class, they indirectly subsidize the liability of the manufacturer, middleman and retailer and in this sense do pay for the insurance policy tied to the product....

For the sake of clarity we restate the extension of the rule. The protections of Section 402 A of the Restatement of Torts 2d extend to bystanders whose injury from the defective product is reasonably foreseeable....

The judgment is reversed and the cause is remanded to the Clark Circuit Court for further proceedings consistent herewith.

Stephenson, J. (dissenting):

I respectfully dissent from the majority opinion to the extent that it subjects the seller to liability. Every rule of law in my mind should have a rational basis. I see none here.

Liability of the seller to the user, or consumer, is based upon warranty. Restatement, Second, Torts s 403A. To extend this liability to injuries suffered by a bystander is to depart from any reasonable basis and impose liability by judicial fiat upon an otherwise innocent defendant. I do not believe that the expression in the majority opinion which justifies this rule for the reason that the seller may procure liability insurance protection is a valid legal basis for imposing liability without fault. I respectfully dissent.

CASE QUESTIONS

1. Why didn't the plaintiff here use warranty as a theory of recovery, as Mr. Seigel did in the previous case?
2. The court offers a rationale for the doctrine of strict products liability. What is it?
3. Restatement, Section 402A, by its terms extends protection "to the ultimate user or consumer," but Mrs. Embs [plaintiff-appellant] was not that. What rationale did the court give for expanding the protection here?
4. Among the entities in the vertical distribution chain—manufacturer, wholesaler, retailer—who is liable under this doctrine?
5. What argument did Judge Stephenson have in dissent? Is it a good one?
6. What is the controlling rule of law developed in this case?

Failure to Warn

Laaperi v. Sears, Roebuck & Co., Inc.

787 F.2d 726 C.A.1 (Mass. 1986)

Campbell, J.

In March 1976, plaintiff Albin Laaperi purchased a smoke detector from Sears. The detector, manufactured by the Pittway Corporation, was designed to be powered by AC (electrical) current. Laaperi installed the detector himself in one of the two upstairs bedrooms in his home.

Early in the morning of December 27, 1976, a fire broke out in the Laaperi home. The three boys in one of the upstairs bedrooms were killed in the blaze. Laaperi's 13-year-old daughter Janet, who was sleeping in the other upstairs bedroom, received burns over 12 percent of her body and was hospitalized for three weeks.

The uncontroverted testimony at trial was that the smoke detector did not sound an alarm on the night of the fire. The cause of the fire was later found to be a short circuit in an electrical cord that was located in a cedar closet in the boys' bedroom. The

Laaperi home had two separate electrical circuits in the upstairs bedrooms: one which provided electricity to the outlets and one which powered the lighting fixtures. The smoke detector had been connected to the outlet circuit, which was the circuit that shorted and cut off. Because the circuit was shorted, the AC-operated smoke detector received no power on the night of the fire. Therefore, although the detector itself was in no sense defective (indeed, after the fire the charred detector was tested and found to be operable), no alarm sounded.

Laaperi brought this diversity action against defendants Sears and Pittway, asserting negligent design, negligent manufacture, breach of warranty, and negligent failure to warn of inherent dangers. The parties agreed that the applicable law is that of Massachusetts. Before the claims went to the jury, verdicts were directed in favor of defendants on all theories of liability other than failure to warn....

Laaperi's claim under the failure to warn theory was that he was unaware of the danger that the very short circuit which might ignite a fire in his home could, at the same time, incapacitate the smoke detector. He contended that had he been warned of this danger, he would have purchased a battery-powered smoke detector as a back-up or taken some other precaution, such as wiring the detector to a circuit of its own, in order better to protect his family in the event of an electrical fire.

The jury returned verdicts in favor of Laaperi in all four actions on the failure to warn claim. The jury assessed damages in the amount of $350,000 [$1,050,000, or about $3,400,000 in 2010 dollars] each of the three actions brought on behalf of the deceased sons, and $750,000 [about $2,500,000 in 2010 dollars] in the action brought on behalf of Janet Laaperi. The defendants' motions for directed verdict and judgment notwithstanding the verdict were denied, and defendants appealed.

Defendants ask us to declare that the risk that an electrical fire could incapacitate an AC-powered smoke detector is so obvious that the average consumer would not benefit from a warning. This is not a trivial argument; in earlier—some might say sounder—days, we might have accepted it.... Our sense of the current state of the tort law in Massachusetts and most other jurisdictions, however, leads us to conclude that, today, the matter before us poses a jury question; that "obviousness" in a situation such as this would be treated by the Massachusetts courts as presenting a question of fact, not of law. To be sure, it would be obvious to anyone that an electrical outage would cause this smoke detector to fail. But the average purchaser might not comprehend the specific danger that a fire-causing electrical problem can simultaneously knock out the circuit into which a smoke detector is wired, causing the detector to fail at the very moment it is needed. Thus, while the failure of a detector to function as the result of an electrical malfunction due, say, to a broken power line or a neighborhood power outage would, we think, be obvious as a matter of law, the failure that occurred here, being associated with the very risk—fire—for which the device was purchased, was not, or so a jury could find....

Finally, defendants contend that the award of $750,000 [$2.5 million in 2010 dollars] in damages to Janet Laaperi was excessive, and should have been overturned by the district court....

Janet Laaperi testified that on the night of the fire, she woke up and smelled smoke. She woke her friend who was sleeping in her room, and they climbed out to the icy roof of the house. Her father grabbed her from the roof and took her down a ladder. She was taken to the hospital. Although she was in "mild distress," she was found to be "alert, awake, [and] cooperative." Her chest was clear. She was diagnosed as having first and second degree burns of her right calf, both buttocks and heels, and her left lower back, or approximately 12 percent of her total body area. She also suffered from a burn of her tracheobronchial mucosa (i.e., the lining of her airway) due to smoke inhalation, and multiple superficial lacerations on her right hand.

The jury undoubtedly, and understandably, felt a great deal of sympathy for a young girl who, at the age of 13, lost three brothers in a tragic fire. But by law the jury was only permitted to compensate her for those damages associated with her own injuries. Her injuries included fright and pain at the time of and after the fire, a three-week hospital stay, some minor discomfort for several weeks after discharge, and a permanent scar on her lower back. Plaintiff has pointed to no cases, and we have discovered none, in which such a large verdict was sustained for such relatively minor injuries, involving no continuing disability.

The judgments in favor of Albin Laaperi in his capacity as administrator of the estates of his three sons are affirmed. In the action on behalf of Janet Laaperi, the verdict of the jury is set aside, the judgment of the district court vacated, and the cause remanded to that court for a new trial limited to the issue of damages.

CASE QUESTIONS

1. The "C.A. 1" under the title of the case means it is a US Court of Appeals case from the First Circuit in Massachusetts. Why is this case in federal court?
2. Why does the court talk about its "sense of the current state of tort law in Massachusetts" and how this case "would be

treated by the Massachusetts courts," as if it were not in the state at all but somehow outside?
3. What rule of law is in play here as to the defendants' liability?
4. This is a tragic case—three boys died in a house fire. Speaking dispassionately—if not heartlessly—though, did the fire actually cost Mr. Laaperi, or did he lose $3.4 million (in 2010 dollars) as the result of his sons' deaths? Does it make sense that he should become a millionaire as a result? Who ends up paying this amount? (The lawyers' fees probably took about half.)
5. Is it likely that smoke-alarm manufactures and sellers changed the instructions as a result of this case?

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19.6: Summary and Exercises

Summary

Products liability describes a type of claim—for injury caused by a defective product—and not a separate theory of liability. In the typical case, three legal doctrines may be asserted: (1) warranty, (2) negligence, and (3) strict liability.

If a seller asserts that a product will perform in a certain manner or has certain characteristics, he has given an express warranty, and he will be held liable for damages if the warranty is breached—that is, if the goods do not live up to the warranty. Not every conceivable claim is an express warranty; the courts permit a certain degree of "puffing."

An implied warranty is one created by law. Goods sold by a merchant-seller carry an implied warranty of merchantability, meaning that they must possess certain characteristics, such as being of average quality for the type described and being fit for the ordinary purposes for which they are intended.

An implied warranty of fitness for a particular purpose is created whenever a seller knows or has reason to know that the buyer is relying on the seller's knowledge and skill to select a product for the buyer's particular purposes.

Under UCC Article 2, the seller also warrants that he is conveying good title and that the goods are free of any rightful claim by a third person.

UCC Article 2 permits sellers to exclude or disclaim warranties in whole or in part. Thus a seller may exclude express warranties. He may also disclaim many implied warranties—for example, by noting that the sale is "as is." The Magnuson-Moss Act sets out certain types of information that must be included in any written warranty. The act requires the manufacturer or seller to label the warranty as either "full" or "limited" depending on what types of defects are covered and what the customer must do to obtain repair or replacement. The act also abolishes "phantom warranties."

Privity once stood as a bar to recovery in suits brought by those one or more steps removed in the distribution chain from the party who breached a warranty. But the nearly universal trend in the state courts has been to abolish privity as a defense.

Because various impediments stand in the way of warranty suits, courts have adopted a tort theory of strict liability, under which a seller is liable for injuries resulting from the sale of any product in a defective condition if it is unreasonably dangerous to the user or consumer. Typical issues in strict liability cases are these: Is the defendant a seller engaged in the business of selling? Was the product sold in a defective condition? Was it unreasonably dangerous, either on its face or because of a failure to warn? Did the product reach the consumer in an unchanged condition? Strict liability applies regardless of how careful the seller was and regardless of his lack of contractual relation with the consumer or user.

Manufacturers can also be held liable for negligence—most often for faulty design of products and inadequate warnings about the hazards of using the product.

The products-liability revolution prompted many state legislatures to enact certain laws limiting to some degree the manufacturer's responsibility for defective products. These laws include statutes of repose and provide a number of other defenses.

EXERCISES

1. Ralph's Hardware updated its accounting system and agreed to purchase a computer system from a manufacturer, Bits and Bytes (BB). During contract negotiations, BB's sales representative promised that the system was "A-1" and "perfect." However, the written contract, which the parties later signed, disclaimed all warranties, express and implied. After installation the computer produced only random numbers and letters, rather than the desired accounting information. Is BB liable for breaching an express warranty? Why?
2. Kate owned a small grocery store. One day John went to the store and purchased a can of chip dip that was, unknown to Kate or John, adulterated. John became seriously ill after eating the dip and sued Kate for damages on the grounds that she breached an implied warranty of merchantability. Is Kate liable? Why?
3. Carrie visited a neighborhood store to purchase some ham, which a salesperson cut by machine in the store. The next day

she made a ham sandwich. In eating the sandwich, Carrie bit into a piece of cartilage in the ham. As a result, Carrie lost a tooth, had to undergo root canal treatments, and must now wear a full-coverage crown to replace the tooth. Is the store liable for the damage? Why?

4. Clarence, a business executive, decided to hold a garage sale. At the sale, his neighbor Betty mentioned to Clarence that she was the catcher on her city-league baseball team and was having trouble catching knuckleball pitches, which required a special catcher's mitt. Clarence pulled an old mitt from a pile of items that were on sale and said, "Here, try this." Betty purchased the mitt but discovered during her next game that it didn't work. Has Clarence breached an express or implied warranty? Why?
5. Sarah purchased several elegant picture frames to hang in her dorm room. She also purchased a package of self-sticking hangers. Late one evening, while Sarah was studying business law in the library, the hangers came loose and her frames came crashing to the floor. After Sarah returned to her room and discovered the rubble, she examined the box in which the hangers were packaged and found the following language: "There are no warranties except for the description on this package and specifically there is NO IMPLIED WARRANTY OF MERCHANTABILITY." Assuming the hangers are not of fair, average, ordinary quality, would the hanger company be liable for breaching an implied warranty of merchantability? Why?
6. A thirteen-year-old boy received a Golfing Gizmo—a device for training novice golfers—as a gift from his mother. The label on the shipping carton and the cover of the instruction booklet urged players to "drive the ball with full power" and further stated: "COMPLETELY SAFE BALL WILL NOT HIT PLAYER." But while using the device, the boy was hit in the eye by the ball. Should lack of privity be a defense to the manufacturer? The manufacturer argued that the Gizmo was a "completely safe" training device only when the ball is hit squarely, and—the defendant argued—plaintiffs could not reasonably expect the Gizmo to be "completely safe" under all circumstances, particularly those in which the player hits beneath the ball. What legal argument is this, and is it valid?
7. A bank repossessed a boat and sold it to Donald. During the negotiations with Donald, Donald stated that he wanted to use the boat for charter service in Florida. The bank officers handling the sale made no representations concerning the boat during negotiations. Donald later discovered that the boat was defective and sued the bank for breach of warranty. Is the bank liable? Why?
8. Tom Anderson, the produce manager at the Thriftway Market in Pasco, Washington, removed a box of bananas from the top of a stack of produce. When he reached for a lug of radishes that had been under the bananas, a six-inch spider—*Heteropoda venatoria*, commonly called a banana spider—leaped from some wet burlap onto his left hand and bit him. Nine months later he died of heart failure. His wife brought an action against Associated Grocers, parent company of Thriftway Market, on theories of (1) strict products liability under Restatement, Section 402(a); (2) breach of the implied warranty of merchantability; and (3) negligence. The trial court ruled against the plaintiff on all three theories. Was that a correct ruling? Explain.
9. A broken water pipe flooded a switchboard at RCA's office. The flood tripped the switchboard circuit breakers and deactivated the air-conditioning system. Three employees were assigned to fix it: an electrical technician with twelve years on-the-job training, a licensed electrician, and an electrical engineer with twenty years of experience who had studied power engineering in college. They switched on one of the circuit breakers, although the engineer said he knew that one was supposed to test the operation of a wet switchboard before putting it back into use. There was a "snap" and everyone ran from the room up the stairs and a "big ball of fire" came after them up the stairs. The plaintiffs argued that the manufacturer of the circuit breaker had been negligent in failing to give RCA adequate warnings about the circuit breakers. How should the court rule, and on what theory should it rule?
10. Plaintiff's business was to convert vans to RVs, and for this purpose it had used a 3M adhesive to laminate carpeting to the van walls. This adhesive, however, failed to hold the fabric in place in hot weather, so Plaintiff approached Northern Adhesive Co., a manufacturer of adhesives, to find a better one. Plaintiff told Northern why it wanted the adhesive, and Northern—Defendant—sent several samples to Plaintiff to experiment with. Northern told Plaintiff that one of the adhesives, Adhesive 7448, was "a match" for the 3M product that previously failed. Plaintiff tested the samples in a cool plant and determined that Adhesive 7448 was better than the 3M product. Defendant had said nothing except that "what they would ship would be like the sample. It would be the same chemistry." Plaintiff used the adhesive during the fall and winter; by spring complaints of delamination came in: Adhesive 7448 failed just as the 3M product had. Over 500 vans had to be repaired. How should the court rule on Plaintiff's claims of breach of (1) express warranty, (2) implied warranty of merchantability, and (3) implied warranty of fitness for a particular purpose?

SELF-TEST QUESTIONS

1. In a products-liability case
    1. only tort theories are typically asserted
    2. both tort and contract theories are typically asserted
    3. strict liability is asserted only when negligence is not asserted

    4. breach of warranty is not asserted along with strict liability
2. An implied warranty of merchantability
    1. is created by an express warranty
    2. is created by law
    3. is impossible for a seller to disclaim
    4. can be disclaimed by a seller only if the disclaimer is in writing
3. A possible defense to breach of warranty is
    1. lack of privity
    2. absence of an express warranty
    3. disclaimer of implied warranties
    4. all of the above
4. Under the strict liability rule in Restatement, Section 402A, the seller is liable for all injuries resulting from a product
    1. even though all possible care has been exercised
    2. regardless of the lack of a contract with the user
    3. in both of the above situations
    4. in none of the above situations
5. An individual selling her car could be liable
    1. for breaching the implied warranty of merchantability
    2. under the strict liability theory
    3. for breaching the implied warranty of fitness
    4. under two of the above

SELF-TEST AnswerS

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

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20: AGENCY

20.1: Introduction
20.2: The Agency Relationship
20.3: Duties of Agents and Principals
20.4: Liability to Third Parties
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20.6: Concluding Thoughts

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20.1: Introduction

Fundamentally, the principles of agency hold individuals and businesses liable for the acts of others. For example, if an employee uses a racial slur against a customer, the business is liable for that employee's discriminatory act. Likewise, if an agent signs a contract in the name of a business, that business may be bound by the terms of the contract.

Agents cannot give themselves power without the express or implied authority of the principal. Once an agency relationship is formed, agents and principals owe each other certain duties. This ensures fair dealings between them and gives third parties some assurance regarding their rights.

Counselor's Corner

Agency is not a sexy area of the law. Most people don't give much thought about it. But I often see cases in my courtroom where people and businesses are liable for the acts of their agents. It doesn't matter if you didn't know the person was legally your agent. You are still responsible for their actions under the law. While there is no way to prevent all mistakes and bad behavior of others, the best way you can insulate yourself from liability of an agent is to surround yourself with people who have integrity. If your grandmother wouldn't approve of them, then you shouldn't work with them. ~Christopher W., judge

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20.2: The Agency Relationship

An agency relationship is created when one person or entity agrees to perform a task for, and under the direction of, another individual or entity. An **agent** is the person who is authorized to act for or in place of another. A **principal** is the person who authorizes another to act on his, her, or its behalf as an agent.

Agency is a fiduciary relationship created by express contract or implied actions, in which the agent has the authority to act on behalf of the principal and legally bind the principal to third parties.

A **fiduciary relationship** is a relationship in which one person is under a duty to act for the benefit of the other on matters within the scope of the relationship. Fiduciary relationships require trust, good faith, and acting in the best interest of the other. In fiduciary relationships, the law requires the fiduciary to act with the highest duty of care. This means that the fiduciary must put the interests of the other party before their own. Examples of fiduciary relationships include doctor-patient, attorney-client, accountant-client, trustee-beneficiary, and guardian-child. An agent is also a fiduciary of a principal.

Types of Principals

There are three types of principals, which are described from the perspective of a third party: disclosed, partially disclosed, and undisclosed.

A **disclosed principal** is a principal whose identity is revealed by the agent to a third party. These are the most common types of principals. For example, employees work for a disclosed principal when they are on the employer's premise, wear a name badge or uniform identifying the employer, or answer the phone by identifying the employer's name.

A **partially disclosed principal** is a principal whose existence, but not actual identity, is revealed by the agent to a third party. In other words, a third party knows that the agent represents a principal but does not know the identity of the principal. For example, a realtor in Aspen may represent celebrities and wealthy individuals who want to purchase property but do not want the paparazzi to publicize the information.

An **undisclosed principal** is a principal whose identity is kept secret by the agent. Often third parties do not realize that an agency relationship exists and believe that the agent is working on his or her own behalf. Undisclosed principals occur when the identity of the principal can lead to increased purchase prices, unwanted publicity, and security concerns.

Types of Agents

An agent is someone who is authorized to act on behalf of a principal. Because there is a variety of authority that a principal can grant an agent, there are many different types of agents. In general, agents are described as either general or special. **General agents** have the authority to transact all the principal's business of a particular kind or in a particular place. General agents often include partners, managers, factors and brokers. **Special agents**, in contrast, only have the authority to conduct a particular transaction or to perform a specific act. Special agents often include realtors, athlete's agents, and employment recruiters.

Some of the most common business agents include:

Agent	Description
Broker	Receives a commission to make contracts with third parties on behalf of a principal
Business agent	Has general power involving the exercise of judgment and discretion, such as a manager or officer
Factor	Receives and sells goods or property for a commission
Forwarding agent	Receives and ships goods for a principal
Independent contractor	Exercises independent judgment on the means used to accomplish the result demanded by principal
Local agent	Acts as a representative to transact business within a specified area

Agent	Description
Ordinary agent	Acts under the direction and control of the principal, such as an employee
Process agent	Authorized to accept legal service of process on behalf of the principal
Registered agent	Authorized to accept legal service of process for a corporation in a particular jurisdiction

Types of Authority

Authority is the right or permission to act legally on another's behalf. In general, authority can be either actual or apparent. **Actual authority**, sometimes called real authority, occurs when a principal intentionally confers authority on an agent. Actual authority can be either express or implied. **Express authority** is authority given by an express agreement, either orally or in writing. **Implied authority** is authority granted to the agent as a result of the principal's conduct.

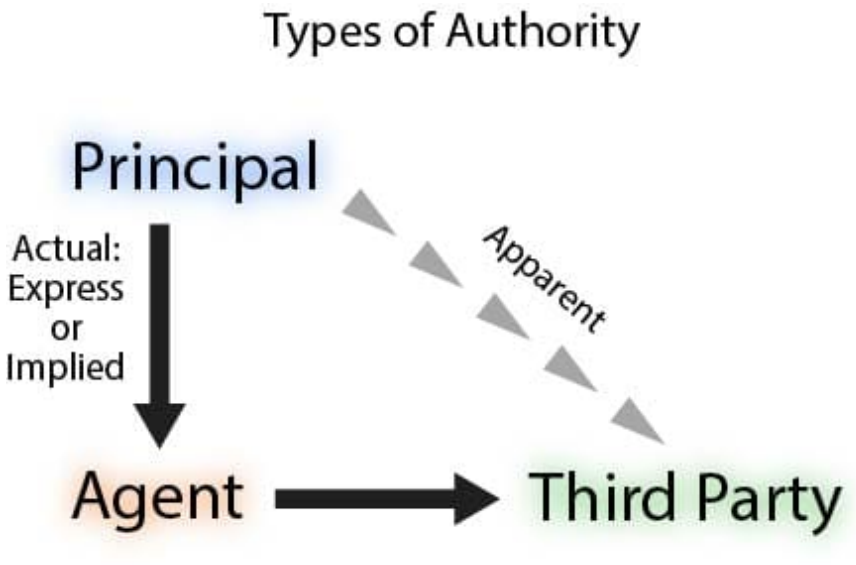


Figure 15.1 Types of Authority

Apparent authority is authority that a third party reasonably believes an agent has, based on the third party's dealings with the principal. If a principal's words or actions lead others to believe that he or she gave authority to someone else, then the principal is held accountable even if no authority was actually given to the agent. For example, if a principal fails to give notice that an agent is no longer working for the principal, the agent may still bind the principal through apparent authority when dealing with third parties.

To constitute apparent authority, three elements must be met:

1. The principal's words or actions lead others to believe the agent has authority;
2. A third party reasonably relies on the principal's words or actions; and
3. The third party is injured.

Sometimes an agent acts without authority. If a disclosed principal likes what an agent does, even if done without authority at the time, the principal can still benefit from the agent's actions. **Ratification** occurs when a disclosed principal adopts or confirms a contract entered into on his or her behalf by an agent who did not have authority to act. Unlike apparent authority, the third party does not have to be injured. Rather, ratification allows principals to enter into contracts for their benefit. Ratification is an "all or nothing" doctrine that prevents principals from ratifying only part of the contract or renegotiating its terms.

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20.3: Duties of Agents and Principals

Because they are in a fiduciary relationship, agents and principals owe each other specific duties. While the duties are similar in nature, there are differences based on their roles.

Duties of Agents



Figure 15.2 Duties of Agents

Agents are fiduciaries of principals and so they are required to act with the highest duty of care. In particular, agents owe principals the following duties:

Duty	Description
Account	Agent must keep proper records to account for all principal's money and property given to agent
Care	Agent must act reasonably, in good faith, and avoid negligence at all times
Inform	Agent must inform principal of all material facts that affect principal's interests
Loyalty	Agent cannot engage in any dealings that compete or interfere with the principal's business or interests
Obedience	Agent must obey all principal's instructions within scope of agency unless they are illegal or unethical
Protect confidential information	Agent cannot use or disclose principal's confidential information

If an agent breaches a duty owed to the principal, the principal has three available remedies:

1. The principal may recover damages the breach has caused;
2. The principal may receive any profit the agent received as a result of a breach of the duty of loyalty; and
3. The principal may rescind a transaction when the duty of loyalty is violated.

Duties of Principals

Principals also owe duties to agents as part of the fiduciary relationship. These duties are:

Duty	Description
Compensation	Principal must pay agent for work performed
Honesty	Principals cannot deceive agents about the nature and scope of the work they are to perform

Duty	Description
Indemnification	Principal must hold agent harmless and free from legal liability for actions properly taken on principal's behalf
Loyalty	Principal cannot engage in any dealings that prevent agent from performing agency tasks
Reimbursement	Principal must reimburse agent for money reasonably expended on behalf of principal



Figure 15.3 Duties of Principals

If a principal breaches a duty owed to the agent, the agent has two available remedies:

1. The agent may recover damages the breach has caused; and
2. The agent may terminate the agency relationship.

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20.4: Liability to Third Parties

An agency relationship affects liability to third parties. The scope of liability depends on the type of principal involved, the type of authority involved, and the nature of the dispute.

Contractual Liability

A principal is always liable on a contract if the the agent had authority. However, the agent's liability on a contract depends on how much the third party knows about the principal. Disclosure, when allowed by the principal, is the agent's best protection against legal liability.

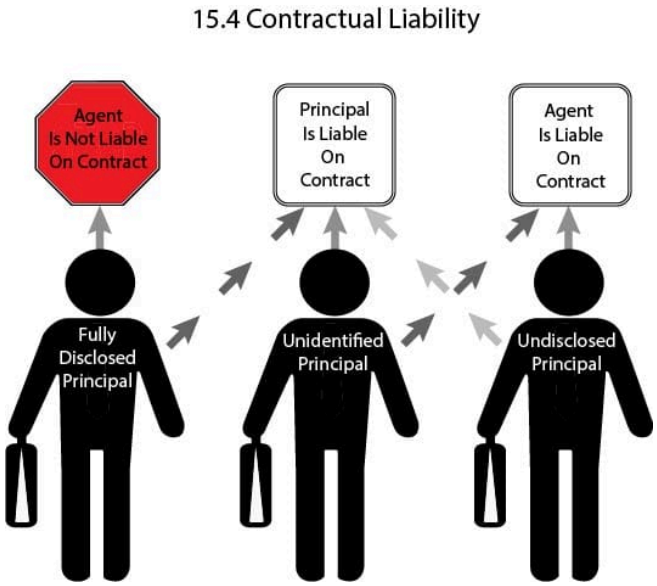


Figure 15.4 When Agents are Liable on Contracts

An agent is not liable for any contracts he or she makes with authority on behalf of a fully disclosed principal. Therefore, if a third party knows the existence and identity of the principal, then all legal liability lies with the principal. The only exception to this is when an agent exceeds his or her authority. In that case, the agent has not acted with authority and becomes personally responsible to the third party. If the agent did not have authority, but the principal later ratifies the contract, then the principal will be liable for the contract.

If a principal is partially disclosed, then the third party may recover from either the principal or agent. In this situation, the principal and agent are jointly and severally liable, and the third party may sue either or both of them to recover the full amount of damages owed. However, the third party cannot seek "double damages" and recover more than the total amount owed for the contractual breach.

In the event of an undisclosed principal, a third party may recover from either the agent or the principal. The fact that a principal's existence or identity is hidden from third parties does not change the nature of the agent-principal relationship. Therefore, undisclosed principals may become liable for contracts entered into by agents acting with actual authority. An undisclosed principal has no liability to an agent or third party when the agent exceeds the actual authority granted by the principal. In addition, the type of contract must be the type that can be assigned to the undisclosed principal. If the contract is for personal services, then liability cannot be assigned to the principal in case of a breach.

Tort Liability

Agents, employees, and independent contractors are personally liable for their own torts. This concept is rooted in the notion that every individual who commits a tort is personally liable to the party who is damaged by the tortious act. The law holds wrongdoers

personally accountable.

However, the reverse is not true. Agents, employees, and independent contractors are not liable for the torts of the principal or employer. If a principal or employer is engaged in tortious behavior, its liability cannot be passed down to its agents and employees.

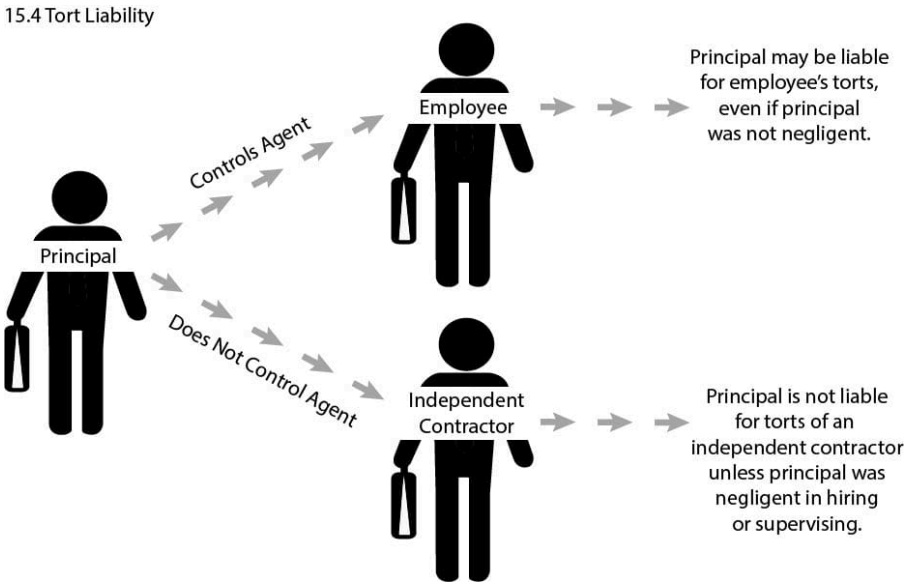


Figure 15.5 When Principals Have Tort Liability for Employees and Independent Contractors

An employer is liable for the torts of an employee if the employee is acting within the scope of employment. This doctrine is called **respondeat superior** and imposes vicarious liability on employers as a matter of public policy. Even if the employer does not direct its employees to act negligently or intentionally, the employer is responsible because employers are usually in a better position to pay for damages than employees. There is also a strong public policy consideration to not allow employers to turn a blind eye to an employee's bad behavior. By making an employer responsible for an employee's actions, it incentivizes the employer to address situations promptly that could lead to potential liability.

Conversely, a principal is not usually liable for the torts of an independent contractor. Independent contractors have the power to control the details of the work they perform and generally are only responsible to a principal for the results of their work. Therefore, independent contractors are not directed and controlled by a principal as employees are by their employers. As a result, the doctrine of respondeat superior does not apply to independent contractors.

Two exceptions exist that may impose liability on a principal for the work of an independent contractor. The first exception is where the work is inherently dangerous. Public policy prevents principals from insulating themselves from the risks of liability by selecting an independent contractor rather than an employee to perform the dangerous work. The second exception is where the work is illegal. Public policy also prevents principals from hiring independent contractors to perform a task that is illegal.

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20.5: Termination of Agency Relationship

Agents and principals may end their agency relationship in various ways. The most common way is through mutual agreement. As a matter of contract, principals and agents may decide to end their relationship. For example, an employee may decide to quit his or her job, or the agency agreement may only be for a set period of time or for a specific transaction.

In addition, there are some events that will terminate an agency relationship as a matter of law. Death of a principal or agent automatically terminates the agency agreement, even if the other party is unaware of the death. Once the time of death is established, any transactions afterward are deemed void.

Similar to death, mental incapacity of a principal or agent terminates an agency relationship. It is often hard to determine the precise time someone loses mental capacity. Therefore, courts often hold that an agent's contract with a third party is binding on the principal unless the third party was aware of the principal's incapacity.

Bankruptcy terminates an agency relationship when the bankruptcy affects the subject matter of the agency agreement. For example, if a principal declares bankruptcy and the real property that an agent is authorized to sell is part of the bankruptcy estate, then the bankruptcy will automatically terminate the agency relationship.

Finally, the destruction or illegality of the subject matter will terminate the agency relationship. For example, if Congress passes a law making it illegal for private parties to sell specific types of weapons, the agency relationship between a gun dealer and its factor for selling those weapons will automatically end.

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20.6: Concluding Thoughts

Agency relationships are flexible and varied depending on the needs and interest of the principals and agents. Because the agency relationship is fiduciary in nature, agents and principals owe each other certain duties. Third parties may hold principals legally liable for the actions of their agents. Therefore, it is important for businesses to select their agents carefully to minimize their risk of liability.

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21: BUSINESS ORGANIZATIONS

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21.1: Introduction

At its most fundamental level, a business exists to make a profit for its owners. Some businesses make things in factories (manufacturers), other businesses sell things that other businesses make (retailers), and still other businesses exist to help both the makers and sellers make and sell better (business consultants). Some businesses don't make things at all, and instead profit by selling their services or by lending money.

With this diversity, it's not surprising that there is no "one size fits all" approach to choosing a business organization. When choosing what form of entity is best, several factors are important to consider:

1. How much it costs to create the entity and how hard it is to create.
2. How easy it is for the business to continue if the founder dies or retires.
3. How difficult it is to raise money to grow or expand the business.
4. What type of managerial control they wish to keep on the business, and whether they are willing to cede control to outsiders.
5. If expanding ownership to members of the public is desired.
6. How to minimize the taxes paid on earnings and income.
7. How to protect personal assets from claims, a feature known as limited liability.

Depending on the type of business and its goals, different business entities may be appropriate.

Counselor's Corner

Selection of business entities is often the first step when going into business. Many entrepreneurs and small businesses do not spend enough time thinking about the legal and tax consequences of the entity they choose. Ironically, an important discussion to have at the beginning is an exit strategy. What happens if one of the business owners becomes ill, dies, or wants to leave the business? What if the economic situation changes and the business no longer is profitable? Discussing exit strategies up front helps people make the best decisions when crises happen. Don't avoid hard conversations up front. It may be uncomfortable but will save a lot of problems down the road. ~Allison W., attorney

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21.2: Sole Proprietorship

A **sole proprietorship** is an unincorporated business owned by one person or married couple. The legal name for a sole proprietorship is usually the owner's name.

There are many advantages to doing business as a sole proprietor. First, it's easy to create a sole proprietorship. In effect, no creation costs or time is required because there is nothing to create. The entrepreneur in charge of the business simply starts doing business, charging money, and providing goods or services.

Another key advantage to sole proprietorship is autonomy. The owner can decide how he or she wants to run the business. The owner can set her own hours, grow as quickly or slowly as she wants, and expand into new lines of businesses. That autonomy also comes with total ownership of the business's finances. All the money that the owner takes in, even if it is in a separate bank account, belongs to her, and she can do with that money whatever she wants.

A sole proprietorship is a **flow-through tax entity**, which means the business does not pay tax on its profits and does not file a separate tax return. Instead, the owner pays personal income tax on all business profits.

These advantages must be weighed against some disadvantages. First, because a sole proprietorship can have only one owner, it is impossible to bring in others to the business. In addition, the business and the owner are identical so it is impossible to pass on the business.

Raising working capital can be a problem for sole proprietors, especially those early in their business ventures. Many entrepreneurial ventures are built on great ideas but need capital to flourish and develop. If the entrepreneur lacks individual wealth, then he or she must seek those funds from other sources. Outsiders can make a loan to the owner, or enter into a profit-sharing contract with her, but there is no way for him to own any part of the owner's business. Traditionally, most sole proprietors seek funding from banks. Banks approach these loans just like any other personal loan to an individual, such as a car loan or mortgage. Down payment requirements may be high, and typically the banks require some form of personal collateral to guarantee the loan, even though the loan is to be used to grow the business.

Sole proprietors are personally liable for all the business's debts and obligations. Unlimited liability puts all the personal assets of the sole proprietor at risk. Personal homes, automobiles, bank accounts and retirement accounts—all are within reach of creditors.

Advantages of Sole Proprietorship	Disadvantages of Sole Proprietorship
• Easy to create • No formal documents or governmental filings required to start business • No formation start up costs • Autonomy • Total control over finances and management decisions	• Flow-through tax entity (owner pays personal income tax on all business profits) • Cannot bring someone else into business • Impossible to pass on the business • Hard to raise capital • Unlimited liability

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21.3: Partnerships

A **partnership** is an unincorporated association of two or more co-owners who operate a business for profit. Each owner is called a **general partner**.

General Partnerships

A **general partnership** is when all partners participate fully in running the business and share equally in profits and losses, even if the partners' monetary contributions vary. No legal documents are required to file with the government to form a partnership. If two or more people do business together, sharing management of the business, profits and losses, they have a partnership.

If a partnership is formed formally, then the written agreement is called the **articles of partnership**. The articles can set forth anything the partners wish to include about how the partnership will be run. Normally, all general partners have an equal voice in management, but as a creation of contract, the partners can modify this if they wish.

A general partnership is taxed just like a sole proprietorship. A partnership is a **flow-through tax entity**, where the partnership's income "flows through" the business to the partners, who then pay individual tax on the business income. The partnership may file an information return, reporting total income and losses for the partnership, and how those profits and losses are allocated among the general partners. However, an information return is usually not required.

General partnerships are also similar to sole proprietorships in unlimited liability. Every partner in the partnership is jointly and severally liable for the partnership's debts and obligations. This is a very unattractive feature of general partnerships. One partner may be completely innocent of any wrongdoing and still be liable for another partner's malpractice or bad acts.

General partnerships are dissolved as easily as they are formed. Since the central feature of a general partnership is an agreement to share profits and losses, once that agreement ends, the general partnership ends with it. In a general partnership with more than two persons, the remaining partners can reconstitute the partnership if they wish, without the old partner. A common issue that arises in this situation is how to value the withdrawing partner's share of the business. Articles of partnership therefore typically include a buy/sell agreement, setting forth the agreement of the partners on how to account for a withdrawing partner's share, which the remaining partners then agree to pay to the withdrawing partner.

Management Duties

Partners have a **fiduciary duty** to the partnership. This means that partners have a duty to act for the benefit of the partnership. In particular:

- Partners have an obligation of good faith and fair dealing with each other and the partnership.
- Partners are liable to the partnership for gross negligence or intentional misconduct. Partners are not liable for ordinary negligence.
- Partners cannot compete with the partnership.
- Partners cannot take opportunities away from the partnership unless the other partners consent.
- Partners cannot engage in conflicts of interest.

Limited Partnerships

In most states, owners can form a limited partnership. A **limited partnership** has both general partners and limited partners. As a limited partner, the most he or she can lose is the amount of his investment into the business, nothing more. Limited partnerships have to be formed in compliance with state law, and limited partners are generally prohibited from participating in day-to-day management of the business. This often occurs when someone invests money in the partnership but is not interested in running the business.

Advantages of Partnerships	Disadvantages of Partnerships
• Easy to create • No formal documents or governmental filings required to start business • Flexibility in sharing management decisions • Allows for investment by limited partners to raise capital • Easy to dissolve	• Flow-through tax entity (owner pays personal income tax on all business profits) • Unlimited liability • May be hard to value individual partner's share of business • Dissolution occurs any time a new partner is added or old partner leaves

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21.4: Franchises

A **franchise** is when a business grants to another the sole right of engaging in a certain business or in a business using a particular trademark in a certain area. Franchises are not a separate form of business organization. Rather, they are a form of contract between businesses. Most franchises involve corporations or limited liability corporations, but they may include sole proprietorships and partnerships.

The advantage of a franchise is that under a **franchise agreement**, an entrepreneur can open and run a business under a proven business model. The local owner, the **franchisee**, uses the **franchisor's** trademark, intellectual property, and business model under a license agreement. The franchisee offers goods or services to the public and keeps any income earned. In exchange for the right to sell goods or services developed by the franchisor, the franchisee pays a fee to the franchisor.

Franchises are common in some industries such as fast food restaurants, hotels, and tax preparation services. Franchise agreements are very detailed and often require the franchisee to use specific vendors, ingredients, store layouts, colors, etc.

Franchises are also very popular with US businesses interested in conducting business abroad. US businesses collect franchise fees from owners in other nations who are responsible for running the business abroad. This allows US companies to have a presence in nations that may restrict business ownership by foreigners because the businesses themselves are owned and operated by locals.

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21.5: Joint Venture

A **joint venture** is when two or more individuals or businesses combine their efforts in a particular business enterprise and agree to share the profits and losses jointly or in proportion to their contributions. Unlike a partnership, which operates as a general business for as long as the partners desire, a joint venture is for a single transaction or a limited activity. The businesses remain separate entities and they do not share financial or confidential information unless they decide to. Joint ventures automatically terminate at the conclusion of an event or project.

Joint ventures are often formed to address a common need or to reach a mutual goal. For example, Google and National Aeronautics and Space Administration (NASA) developed Google Earth as a joint venture. To do so, they shared resources and information necessary to develop Google Earth but Google did not become part of the government, nor did NASA share any confidential information or intellectual property more than necessary.

Joint ventures are also common to share the costs of major research or infrastructure projects within an industry. This occurs frequently when industries are impacted by advances in technology. For example, BMW and Toyota created a joint venture to research hydrogen fuel cells, electric vehicles, and ultra-lightweight materials needed in next generation vehicles. By sharing the cost of research and development, the companies are able to be on the forefront of technological advancements in their industry.

Franchises	Joint Ventures
• The right to use a trademark by paying a fee to the franchisor • Contract isn't separate from the business • Franchise either offers a good or a service • Mainly used in conducting business abroad	• Share a mutual goal/cost/losses • Combines efforts in a single transaction or a limited activity • Agreement becomes terminated at the end of the event or project • Financial and confidential information is not shared

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21.6: Corporations

Unlike a sole proprietorship or general partnership, a corporation is a legal entity separate and distinct from its owners. It can be created for a limited duration, or it can have a perpetual existence. Since it is a separate legal entity, a corporation has continuity regardless of its owners. Similarly, in a publicly traded company, the identity of shareholders can change, but the corporation continues its business operations without being affected.

Corporations must be formed in compliance with the law of the state law where they are incorporated. Most corporations incorporate where their principal place of business is located, but not all do. Many companies choose to incorporate in Delaware. Delaware chancery courts have developed a reputation for fairly and quickly applying a very well-developed body of corporate law in Delaware. The courts also operate without a jury, meaning that disputes heard in Delaware courts are usually predictable and transparent, with well-written opinions explaining how the judges decided the cases.

To start a corporation, the corporate founders must file **articles of incorporation** with the Secretary of State where they are incorporated. Articles of incorporation typically include:

- The name of the company;
- Whether the company is for-profit or nonprofit;
- The founders' names;
- The company's purpose;
- How many shares the corporation will issue initially; and
- The par value of any shares issued.

Unlike sole proprietorships, corporations can be quite complicated to manage and often require attorneys and accountants to maintain corporate books in good order. In addition to the foundation requirements, corporate law requires ongoing annual maintenance of corporations. In addition to filing fees due at the time of incorporation, there are typically annual license fees, franchise fees and taxes, and fees related to maintaining minute books, corporate seals, stock certificates and registries, as well as out-of-state registration. A domestic corporation is entitled to operate in its state of incorporation but must register as a foreign corporation to do business in other states.

Corporate Legal Structure

Owners of corporations are called **shareholders**. Corporations can have as few as one shareholder or as many as millions of shareholders, and those shareholders can hold as few as one share or as many as millions of shares. In a **closely held corporation**, the number of shareholders tends to be small, while in a **publicly traded corporation**, the body of shareholders tends to be large.

In a publicly traded corporation, the value of a share is determined by the laws of supply and demand, with various markets or exchanges providing trading space for buyers and sellers of certain shares to be traded. Shareholders own shares in the company but have no legal right to the company's assets. As a separate legal entity, the corporation owns any property in its name.

Shareholders of a corporation enjoy limited liability. The most they can lose is the amount of their investment. Shareholders' personal assets are not available to the corporation's creditors.

Shareholders can be individuals or other business entities, such as partnerships or corporations. If one corporation owns all the stock of another corporation, the owner is said to be a **parent company**, while the company being owned is a **wholly owned subsidiary**. Often large corporations form subsidiaries for specific purposes so that the parent company has limited liability or advantageous tax treatment. For example, large companies may form subsidiaries to hold real property so that premises liability is limited to that real estate subsidiary only, shielding the parent company and its assets from lawsuits. Companies that deal in a lot of intellectual property may form subsidiaries to hold their intellectual property, which is then licensed back to the parent company so that the parent company can deduct royalty payments for those licenses from its taxes. This type of sophisticated liability and tax planning makes the corporate form very attractive for larger businesses in the United States.

An exception to the rule of limited liability arises in certain cases involving closely held corporations. Many sole proprietors incorporate their businesses to gain limited liability but fail to realize when they do so that they are creating a separate legal

entity that must be respected as such. If sole proprietors fail to respect the legal corporation with an arm's length transaction, then creditors can ask a court to pierce the corporate veil. If a court agrees, then limited liability disappears and those creditors can reach the shareholder's personal assets.

Rights of Shareholders

Not all shareholders in a corporation are necessarily equal. US corporate law allows for the creation of different types, or classes, of shareholders. Shareholders in different classes may be given preferential treatment when it comes to corporate actions such as paying dividends or voting at shareholder meetings.

Shareholder rights are generally outlined in a company's articles of incorporation or bylaws. Some of these rights may include the right to obtain a dividend, but only if the board of directors approves one. They also include the right to attend shareholder meetings, the right to examine the company's financial records, and the right to a portion of liquidated company assets.

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

One of the most important functions for shareholders is to elect the board of directors of a corporation. Only shareholders elect a director. The board is responsible for making major decisions that affect a corporation, such as declaring and paying a corporate dividend to shareholders; authorizing major decisions; appointing and removing corporate officers; determining employee compensation, especially bonus and incentive plans; and issuing new shares and corporate bonds.

One critical function for boards of directors is to appoint corporate officers. These officers often hold titles such as chief executive officer, chief operating officer, chief marketing officer, and so on. Officers are involved in everyday decision making for the company and implement the board's decisions. As officers of the company, they have legal authority to sign contracts on behalf of the corporation, binding the corporation to legal obligations. Officers are employees of the company and work full-time for the company, but can be removed by the board.

Corporate Taxation

Corporations are subject to double taxation. Because corporations are separate legal entities, they must pay federal, state, and local tax on net income. Then, if the board of directors declares a dividend, shareholders are taxed on the dividend that they receive in the form of a dividend tax.

One way for closely held corporations (such as small family-run businesses) to avoid double taxation is to form an S corporation. An S corporation (the name comes from the applicable subsection of the tax law) can choose to be taxed like a partnership or sole proprietorship. In other words, taxes are only collected when a dividend is declared and not on corporate net income. An S corporation is formed and treated just like any other corporation; the only difference is in tax treatment.

S corporations provide the limited liability feature of corporations but the single-level taxation benefits of sole proprietorships. There are some important restrictions on S corporations, however. They cannot have more than one hundred shareholders, all of whom must be US citizens or resident aliens and cannot include partnerships and corporations. S corporations can have only one class of stock and there are restrictions on how shares may be transferred. Finally, all shareholders must agree that the company should be an S corporation. These restrictions ensure that "S" tax treatment is reserved only for small businesses.

Advantages of Corporations	Disadvantages of Corporations
• Separate legal entity from owners • Corporation unaffected by change of ownership/ shareholders • Limited liability for shareholders • Not subject to some laws • Considered as an "individual" with Constitutional rights	• Formal documents required to filed in state of incorporation • Can be complicated to manage • High formation and maintenance costs • Subject to double taxation • Heavily regulated by government

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21.7: Limited Liability Entities

A **limited liability company (LLC)** is a "hybrid" form of business organization that offer the limited liability feature of corporations but the tax benefits of partnerships. Owners of LLCs are called **members**. Just like a sole proprietorship, it is possible to create an LLC with only one member. LLC members can be individuals or other LLCs, corporations, or partnerships. LLC members can participate in day-to-day management of the business.

Members are not personally liable for the debts of the business. Like shareholders of a corporation, members of an LLC risk only their financial investment in the company.

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

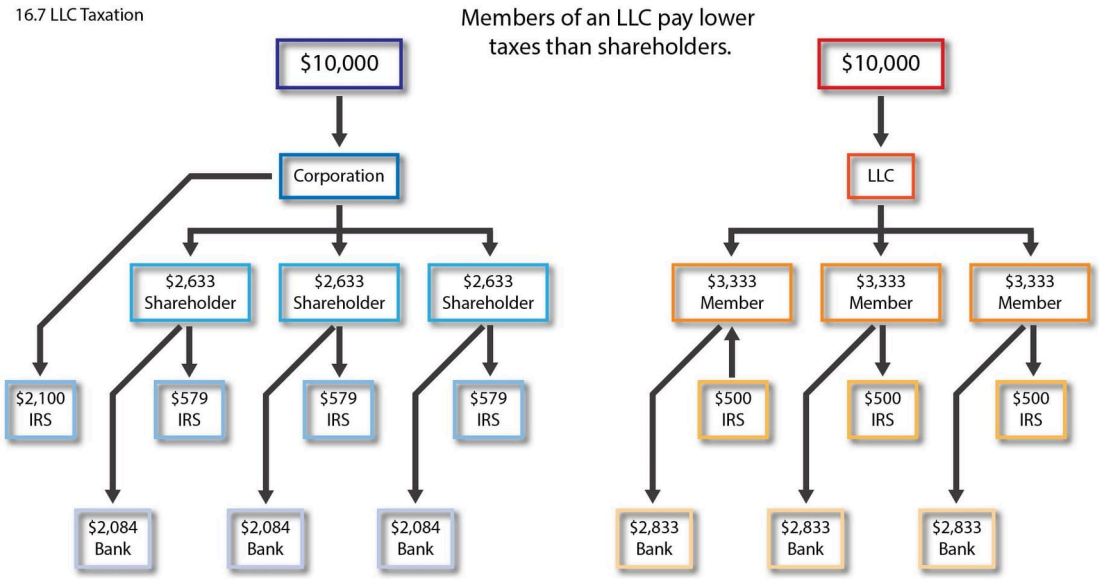


Figure 16.1 LLC Taxation

LLCs are formed by filing the articles of organization with the state agency charged with chartering business entities, typically the Secretary of State. Starting an LLC is often easier than starting a corporation. Typical LLC statutes require only the name of the LLC and the contact information for the LLC's legal agent. Unlike corporations, there is no requirement for an LLC to issue stock certificates, maintain annual filings, elect a board of directors, hold shareholder meetings, appoint officers, or engage in any regular maintenance of the entity. Most states require LLCs to have the letters "LLC" or words "Limited Liability Company" in the official business name.

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

Since LLCs are a separate legal entity from their members, members must take care to interact with LLCs at arm's length, because the risk of piercing the veil exists with LLCs as much as it does with corporations. Fundraising for an LLC can be as difficult as it is for a sole proprietorship, especially in the early stages of an LLC's business operations. Most lenders require LLC members to personally guarantee any loans the LLC may take out. Finally, LLCs are not the right form for taking a company public and selling stock. Fortunately, it is not difficult to convert an LLC into a corporation, so many start-up business begin as LLCs and eventually convert into corporations prior to their initial public offering (IPO).

Advantages of LLCs	Disadvantages of LLCs
• Limited liability for owners • Flow-through tax entity so not subject to double taxation • Easier to form and operate than corporation or S corporation • Owners can deduct losses for personal taxes	• Subject to state laws so lacks consistency in enforcement • Laws not as developed as corporate law & partnership law

Limited Liability Partnerships

A related entity to the LLC is the limited liability partnership, or LLP. Be careful not to confuse limited liability partnerships with limited partnerships. LLPs are just like LLCs but are designed for professionals who do business as partners. They allow the partnership to pass through income for tax purposes, but retain limited liability for all partners. LLPs are especially popular with doctors, architects, accountants, and lawyers. Most of the major accounting firms have now converted their corporate forms into LLPs.

Professional Corporations

Professional Corporations (PCs) are mostly a legacy form of organization. In other words, before LLCs and LLPs were an option, PCs were the only option available to professionals who wanted limited liability. Some states still require doctors, lawyers, and accountants to organize as a PC.

If a member of a PC commits malpractice, the PC's assets are at risk along with the personal assets of the member who committed malpractice. However, the personal assets of the non-involved members are not at risk. PCs do not shield individuals from their own malpractice but they offer limited liability to innocent members.

PCs are a separate taxable entity but they are not flow-through entities like partnerships. As a result, taxation of PCs is complicated and a major drawback of this form of business entity.

Type of Business Organization	Ease of Formation	Funding	Personal Liability for Owners	Taxes	Ease of Transferring Ownership	Perpetual Existence	Dissolution
Sole Proprietorship	Very easy	Same as owner	Yes	Flow-through	Must sell entire business	No	When & how owner decides
General Partnership	Easy	Partners contribute capital	Yes	Flow-through	Hard	No	Upon death, bankruptcy, agreement, or termination of partnership
Limited Partnership	Easy	Partners contribute capital	General partner is personally liable; limited liability for limited partners	Flow-through	Hard	No	Upon death, bankruptcy, agreement, or termination of partnership
Corporations	Difficult	Sell stock to raise capital	No	Subject to double taxation	Easy	Yes	By resolution of board of directors, bankruptcy, or court order

Type of Business Organization	Ease of Formation	Funding	Personal Liability for Owners	Taxes	Ease of Transferring Ownership	Perpetual Existence	Dissolution
S Corporations	Difficult	Sell stock to raise capital	No	Taxed only on dividends	Transfer restrictions	Yes	By resolution of board of directors, bankruptcy, or court order
Limited Liability Companies (LLCs)	Medium	Members make capital contributions	No	Flow-through	Depends on operating agreement	Varies by state; yes in most states	Upon death, bankruptcy, agreement, or court order
Limited Liability Partnerships (LLPs)	Difficult	Members make capital contributions	Non-acting partners have limited liability; state law varies regarding liability of acting partners vs. partnership	Flow-through	Depends on the partnership agreement	Depends on partnership agreement	Upon death, bankruptcy, agreement, or termination of partnership
Professional Corporations	Difficult	Members make capital contributions	No	Complex tax issues	Transfer restricted to members of the same profession	Yes, as long as it has shareholders	Upon death, bankruptcy, agreement, or court order

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21.8: Concluding Thoughts

Depending on a business's type and goals, different business entities may fit the needs of owners better than others. It is important when starting a business to decide how to minimize tax and liability exposure and to maximize profits. Because there is no perfect "fit" for every business need, understanding the advantages and disadvantages of the various business entities is important.

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