

BUSINESS LAW



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CHAPTER OVERVIEW

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- 1.1: Introduction
- 1.2: Basic American Legal Principles
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1.1: Introduction

Learning Objectives

- Describe the foundation and sources that establish American law.



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1.2: Basic American Legal Principles

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

Establishing Standards

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



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

Promoting Consistency

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

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

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

Maintaining Order

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

Resolving Disputes

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

Protecting Liberties and Rights

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

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

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

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1.3: Sources and Types of Law

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

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

The Constitution

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



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

American Common Law

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

An example of how case law works is the case of the State v. Wayfair Inc. (2017 SD 56, 901 N.W.2d 754 (S.D. 2017), cert. granted, 138 S. Ct. 735 (2018)), in which the South Dakota Supreme Court held that a state law requiring internet retailers without an in-state physical presence to remit sales tax was unconstitutional. Unless this ruling is overruled by the United States Supreme Court, it becomes part of the case law and precedent set in that state, and it will be followed by subsequent rulings when similar cases are filed.

Federal Law

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

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

Statutes

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

Regulations

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

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

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

State Law

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

Local Law

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

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

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1.4: Important Business Laws and Regulations

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



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

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

Disputes and Dispute Settlement

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

Business Ethics and Social Responsibility

In the routine course of business, employees are often required to make decisions. Business ethics outline the ethical model, or framework, that companies expect employees to follow when making these decisions, as well as the behavior that the companies deem acceptable. Sound and ethical decision-making can also help companies avoid legal liability and exposure. Typically, an ethics code and/or a code of conduct details a company’s requirements and guidelines, while also serving as a key corporate governance tool.

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

Business and the United States Constitution

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

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

Criminal Liability

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

Torts

A tort is a civil wrong, other than a breach of contract, that causes injury or harm to another person and can result in legal liability for the one who committed the wrongful act. In other words, it is an act or omission that infringes a legal right or causes loss, for which the injured party may seek remedies such as monetary damages or an injunction in a civil lawsuit. Within the business law context, torts may involve either intentional torts or negligence. Additionally, companies involved in certain industries should consider the risk of product liability. Product liability involves a legal action against a company by a consumer for a defective product that caused loss or harm to the customer. There are several theories regarding recovery under product liability. These include contract theories that deal with the product warranty, which details the promises of the nature of the product sold to customers. The contract product warranty theories are Express Warranty, Implied Warranty of Merchantability, and Implied Warranty of Fitness. Tort theories deal with a consumer claim that the company was negligent, and therefore caused either bodily harm, emotional harm, or monetary loss to the plaintiff. The tort liability theories that can be used in this context are negligence (failure to take proper care in something), strict liability (imposition of liability without a finding of fault), and acts committed under Restatement (Third) of Torts (basic elements of the tort action for liability for accidental personal injury and property damage, as well as liability for emotional harm).

Contracts

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

Employment and Labor Law

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

Antitrust Law

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

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

Unfair Trade Practices and the Federal Trade Commission

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

Securities Regulation

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

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

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1.5: Commerce Clause

The Constitution and the Law

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



Figure 1.5.1: The United States Constitution is the supreme law of the land. (Credit: 1778011/ pixabay/ License: CC0)

Federal Preemption

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

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

Immigration concerns have been ever-present in recent media/news. Most often, the topics around sanctuary cities and blocking federal proceedings of immigration policing are at the heart of a lot of disagreement. Federal power over immigration is often described as **plenary**, meaning the national government has primary and nearly complete authority to decide which noncitizens may enter, remain in, or be removed from the United States. This authority is grounded partly in the Constitution’s grant to Congress of a power to establish a “uniform Rule of Naturalization,” and more broadly in the idea that regulating a nation’s borders and foreign relations is an inherent attribute of national sovereignty. In practice, Congress designs the overall immigration system, while the executive branch, primarily through agencies within the Department of Homeland Security and the Department of Justice, implements and enforces those laws by adjudicating applications, policing the border, and conducting removal proceedings.

Preemption in immigration law is an application of the Supremacy Clause, under which valid federal law overrides conflicting state law. Because immigration is treated as a matter of national, not local, concern, the Supreme Court has held that states may not create their own rules determining which noncitizens may enter, stay, or be expelled, and state measures that intrude into this domain are often preempted. Some state laws touching on immigrants, such as certain licensing or employment regulations, can survive if they operate in traditional state areas and do not conflict with congressional objectives or a comprehensive federal scheme, but any state law that effectively regulates immigration status or obstructs federal enforcement priorities is vulnerable to being struck down under preemption principles.

The Commerce Clause and The Affordable Care Act

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

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

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

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

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

Challenges to and Reinterpretations of the Commerce Clause

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

Examples of Federal Legislation Passed by Invoking the Commerce Clause

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

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

A recent controversy pertaining to the commerce clause relates to the passing of the Affordable Care Act, as described earlier. Protestors claimed that the individual mandate aspect of the ACA should be treated as a regulation that affects interstate commerce. According to their argument, after the Act was implemented, there would be an increase in the sale and purchase of health care insurance, such that the market for health care should be seen as being significantly impacted by the Act. However, the Chief Justice of the Supreme Court, Justice Roberts, ruled that actions that create new business activity do not affect interstate commerce. Ultimately, the Affordable Care Act was viewed as a tax, and that is something Congress has the power to do.

Wisconsin’s auto insurance requirements are generally not viewed as violating the Commerce Clause because they regulate intrastate activity (driving within Wisconsin and insurance contracts tied to vehicles garaged and operated there) rather than discriminating against or directly burdening interstate commerce. State insurance law has long been treated as part of the states’ traditional police powers over highways, public safety, and local insurance markets, and Congress has affirmatively left primary regulation of insurance to the states through the McCarran–Ferguson Act, which undercuts Commerce Clause objections to such state schemes.

Police Power and the Dormant Commerce Clause

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

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

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

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

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

Table 1.5.1

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

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1.6: Constitutional Protections

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

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

Table 1.6.1

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

Application of the Bill of Rights to Commercial Activity

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

The First Amendment

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

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

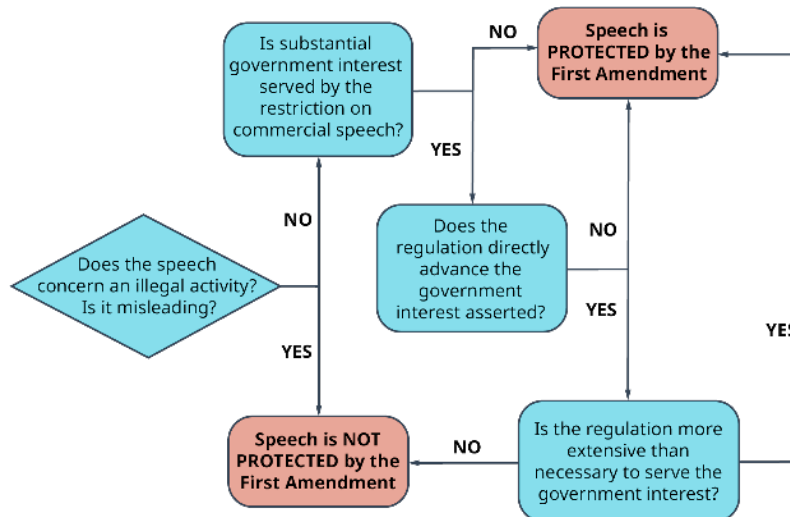


Figure 1.6.1: Hudson Gas & Electric Corp v. Public Service Commission of New York established a four-part test to determine whether commercial speech should be regulated according to the First Amendment. (Modification of art by BNED/pixabay Credit: CC BY NC SA)

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

The Fourth Amendment

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

The Fifth Amendment

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

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

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

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

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

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



Figure 1.6.2: The various protections afforded the citizenry in the Bill of Rights are also extended to corporations and commercial activities. (Credit: Anthony Garand/ unsplash/ License: Unsplash License)

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CHAPTER OVERVIEW

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2.1: Introduction

Learning Objectives

After reading this chapter, you should have a thorough understanding of the U.S. court system and how it affects the conduct of businesses and individuals. Specifically, you should be able to answer the following questions:

- What role does each of the three branches of government play?
- How do the other two branches of government balance the judiciary?
- How are the state and federal courts structured?
- What are the primary differences between trial and appellate courts?
- How does the Supreme Court do its work?

As you now know, laws are meaningless if they are not enforced. Companies have to make a barrage of decisions daily, from product development to marketing to strategies to maintain growth, but most of these are based on sound business acumen rather than legal requirements. If a company does violate a law, however, it must be held accountable. Typically, that accountability comes in the form of a lawsuit heard in court. Whether a suit is brought by a supplier, customer, employee, shareholder, or other stakeholder, litigation is a fact of life for companies. As future business professionals, being familiar with our court system will lay the foundation for your understanding of the litigation process.

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2.2: The Supreme Court

Learning Objectives

- Understand the constitutional basis for the judicial branch.
- Explore the differences among the three branches of government.
- Learn about the chief justice's role in judicial administration.
- Explore the concept of judicial review.
- Become familiar with how the other two branches check and control the judiciary.

Under the federal Constitution, power is separated among the three branches of government. Article I of the Constitution allocates the legislative power to Congress, which is composed of the House of Representatives and the Senate. Congress makes laws and represents the will of the people in doing so. Article II of the Constitution creates the executive power in the president and makes the president responsible for enforcing the laws passed by Congress. Article III of the Constitution establishes a separate and independent judiciary, which is in charge of applying and interpreting the meaning of the law. The U.S. Supreme Court sits at the top of the federal judiciary as the supreme court of the land. There are nine judges on the Supreme Court. (See Figure 2.2.1 "The U.S. Supreme Court in 2022".)



Figure 2.2.1: Formal group photograph of the Supreme Court as it was comprised on June 30, 2022, after Justice Ketanji Brown Jackson joined the Court. The Justices are posed in front of red velvet drapes and arranged by seniority, with five seated and four standing. Seated from left are Justices Sonia Sotomayor, Clarence Thomas, Chief Justice John G. Roberts, Jr., and Justices Samuel A. Alito and Elena Kagan. Standing from left are Justices Amy Coney Barrett, Neil M. Gorsuch, Brett M. Kavanaugh, and Ketanji Brown Jackson. Photo Credit: Fred Schilling: Collection of the Supreme Court of the United States - <https://www.supremecourt.gov/about/justices.aspx>

The Constitution is remarkably short in describing the judicial branch. The president, under Article II, has the power to nominate judges with the advice and consent of the Senate. Article III also provides the following: “The judicial power of the United States, shall be vested in one Supreme Court, and in such inferior courts as the Congress may from time to time ordain and establish. The judges, both of the supreme and inferior courts, shall hold their offices during good behaviour, and shall, at stated times, receive for their services, a compensation, which shall not be diminished during their continuance in office.” Under the Constitution, therefore, there are only two requirements to becoming a federal judge: nomination by the president and confirmation by the Senate. There are no age, citizenship, or qualification requirements. If the president wanted to, he could nominate any reader of this book as a federal judge. Additionally, the Constitution guarantees that judges are relatively free from political interference by providing them with lifetime tenure and a salary that cannot be reduced.

It is commonly accepted that the three branches of government are coequal, but in reality, they are very different. The judiciary is the only unelected branch of government and is therefore the most mysterious. Although many Americans know who the president is, and many are familiar with their representatives in Congress, very few know the names of the judges who sit on the Supreme Court or any lower court. When politicians run for Congress or president, they spend months campaigning, begging voters to look into their eyes and trust them enough to cast their votes. Since judges are not elected, the vast majority of Americans cannot associate them with a face. Indeed, many visitors to the Supreme Court building in Washington, DC, routinely come face-to-face with a justice and don't realize it.

The three branches also consume vastly different resources in serving the public, with the entire federal court system consuming less than two-tenths of 1 percent of the federal budget. The political branches capture the public imagination with monuments and landmarks (Air Force One, the White House, the Capitol), while the federal judiciary works in relative anonymity. (All federal judges, for example, travel commercially and do not have access to government-owned planes.) Finally, the judiciary is designed to be the most remote branch from the people. In addition to being unelected, federal judges have life tenure and can be removed from office only through impeachment. They also tend to be in public office far longer than politicians. While the United States has had forty-four presidents and more than two thousand members of Congress, Chief Justice John Roberts is only the seventeenth chief justice. Roberts was only fifty years old when he became chief justice and will likely be chief justice for many decades to come, certainly long after his nominating president, George W. Bush, has faded from public life.

When we speak of the “federal judiciary,” we are referring to a very small entity compared to other federal bureaucracies. The Supreme Court (the building, justices, and staff) is one part of the federal judiciary. The district and appellate courts (described later in this chapter) are another part, and they also comprise judges and staff (although these courts do not own their own buildings; rather, all courts other than the Supreme Court are rented from other branches of the government). The Administrative Office of the United States Courts runs the day-to-day issues for all the courts, such as payroll and rent. A second component of the judiciary is the Federal Judicial Center, an agency dedicated to conducting research on judicial administration and providing judicial education. A third component is the United States Sentencing Commission (USSC), established by Congress to make recommendations on how to establish uniformity in federal criminal sentencing. In addition to his responsibilities in hearing cases and writing opinions, the chief justice oversees the overall operation of the federal courts and represents the courts to the other branches of government. When it comes to hearing and deciding cases, however, the chief justice is “first among equals”: he has no more power than any of the other justices, known as associate justices.

In that capacity, the chief justice traditionally releases an annual report on the judiciary. Since becoming chief justice in 2005, Chief Justice Roberts (Figure 2.2.2 “Chief Justice John G. Roberts”) has focused his annual reports on judicial pay. Although judicial salaries cannot be reduced, years have passed since Congress approved a cost-of-living increase for judges. District court judges are currently paid \$169,300 (the same salary as members of Congress), while circuit court judges are paid \$179,500. Supreme Court justices earn \$208,100, and the chief justice earns \$217,400. While this may seem like a lot of money, it’s important to keep in mind that the integrity of the judicial system depends on attracting the very best lawyers to join the bench. Lawyers of that caliber are also in high demand in private law firms, where they can earn many times more than what judges earn. As a result, high-quality lawyers who otherwise may serve the country by becoming judges never even consider joining the bench. As you can see from “Learn More: Excerpt from 2008 Year-End Report to Congress”, there is a risk, the chief justice believes, that the pool of judicial talent may be limited to less-than-the-best lawyers or those who are independently wealthy.



Figure 2.2.2: Chief Justice John G. Roberts. Source: Photo courtesy of the Supreme Court of the United States, [Wikipedia \[en.Wikipedia.org\]](https://en.wikipedia.org).

Learn More: Excerpt from 2008 Year-End Report to Congress

From the [2008 Year-End Report to Congress](#).

I suspect many are tired of hearing it, and I know I am tired of saying it, but I must make this plea again—Congress must provide judicial compensation that keeps pace with inflation. Judges knew what the pay was when they answered the call of public service. But they did not know that Congress would steadily erode that pay in real terms by repeatedly failing over the years to provide even cost-of-living increases.

Last year, Congress fell just short of enacting legislation, reported out of both House and Senate Committees on the Judiciary, that would have restored cost-of-living salary adjustments that judges have been denied in past years. One year later, Congress has still failed to complete action on that crucial remedial legislation, despite strong bipartisan support and an aggregate cost that is minuscule in relation to the national budget and the importance of the Judiciary's role. To make a bad situation worse, Congress failed, once again, to provide federal judges an annual cost-of-living increase this year, even though it provided one to every other federal employee, including every Member of Congress. Congress's inaction this year vividly illustrates why judges' salaries have declined in real terms over the past twenty years.

Our Judiciary remains strong, even in the face of Congress's inaction, because of the willingness of those in public service to make sacrifices for the greater good. The Judiciary is resilient and can weather the occasional neglect that is often the fate of those who quietly do their work. But the Judiciary's needs cannot be postponed indefinitely without damaging its fabric. Given the Judiciary's small cost, and its absolutely critical role in protecting the Constitution and rights we enjoy, I must renew the Judiciary's modest petition: Simply provide cost-of-living increases that have been unfairly denied! We have done our part—it is long past time for Congress to do its.

The Supreme Court is a well-known institution today, but it wasn't always that way. When the Court first met, many of the justices (then appointed by George Washington) couldn't travel in time for the Court's opening day, so the session was dismissed. For the first three years of its existence, the Court heard no cases of any importance. John Jay, the first chief justice, traveled to Europe while he was chief justice to negotiate the Jay Treaty with Great Britain. While there, he won the election as governor of New York. He was reappointed as chief justice by President Washington and confirmed by the Senate, but declined to return to the Court, citing the Court's lack of energy, weight, and dignity as part of his reasoning. It wasn't until John Marshall became the fourth chief justice (a position he held for a record thirty-four years) that the Supreme Court firmly established itself as a separate and coequal branch of government. The Supreme Court did not even get its own building until 1932, years after the nation's capital was established in Washington, DC. Before then, it met in the basement of the old Senate building to hear cases. When William Taft (the only president who also served as a Supreme Court justice) became chief justice, he persuaded Congress to appropriate funds, and the Court finally got its own building in Washington, DC.

The Supreme Court's early malaise can partially be attributed to the problem that no one really had a good idea of what the Supreme Court was supposed to do. There were a few cases of tremendous national importance in the new republic, and a quirky tradition known as "riding circuit" meant that the Supreme Court justices also acted as lower appellate court judges, thus making their work at the Supreme Court somewhat duplicitous. The Constitution simply states that the judicial power of the United States is vested in the Supreme Court, without expounding what that means. It wasn't until 1803 that the modern role of the Supreme Court began to emerge.

In 1800, the presidential election between John Adams and Thomas Jefferson nearly tore the country apart. The election was bitter, partisan, and divisive. Jefferson won but wasn't declared the winner until early in 1801. In the meantime, Adams and other Federalists in Congress attempted to leave their mark on government by creating a slate of new life-tenured judgeships and appointing Federalists to those positions. For the judgeships to become effective, certain paperwork (known as commissions) had to be delivered in person to the new judges. At the time power transitioned from Adams to Jefferson, several commissions had not been delivered, and Jefferson ordered his acting secretary of state to stop delivering them. When Jefferson came to power, there was not a single judge from his Democratic-Republican Party sitting on the bench, and he wasn't keen on expanding the Federalist influence on the bench any further. One Federalist judge, William Marbury, sued the Secretary of State, James Madison, to deliver his commission. The case was filed in the Supreme Court, led by Chief Justice John Marshall (Figure 2.2.3 "Chief Justice John Marshall"). Marshall himself was a Federalist and had served as Adams's secretary of state, so he understood how political the case was and how he stood to be accused of bias if he ruled the wrong way. In a shrewd and calculated move, he ultimately ruled against Marbury but at the same time declared that it was the Supreme Court's role to decide the meaning of the Constitution. This is called judicial review, and it makes the U.S. Supreme Court the most powerful judicial body in the world. The following is from *Marbury v. Madison*: "It is emphatically the province and duty of the Judicial Department to say what the law is. Those who apply the rule to particular cases must, of necessity, expound and interpret that rule. If two laws conflict with each other, the Courts must decide on the operation of each." *Marbury v. Madison*, 5 U.S. 137 (1803).



Figure 2.2.3: Chief Justice John Marshall. Source: Photo courtesy of the U.S. Department of State, [Flickr \[www.flickr.com\]](https://www.flickr.com/photos/departmentofstate/10000000000/).

Chief Justice Marshall did not invent judicial review; it is a feature of most common-law countries and as a concept goes back centuries. He did, however, institutionalize judicial review at the U.S. Supreme Court at a time when there was great uncertainty about the Court's future role in government. While all three branches are bound to uphold the Constitution, on all matters relating to the meaning of the Constitution, the Supreme Court has the final say.

After *Marbury v. Madison*, it took the Supreme Court nearly sixty years to again use the power of judicial review to strike down legislation. The case was *Dred Scott v. Sanford*, *Dred Scott v. Sanford*, 60 U.S. 393 (1857). and it involved a slave who traveled with his owner, a doctor in the army, to many states, including free states (Figure 2.2.4 "Dred Scott"). Dred Scott filed suit for his freedom, and the case ended up before the Supreme Court. In what many commentators call the Supreme Court's "self-inflicted injury," the Court, in an opinion written by Chief Justice Roger Taney, used judicial review to overturn the Missouri Compromise and held that Dred Scott was not a person under the Constitution and therefore could not file suit. The decision hastened the country into Civil War, and it took years for the Supreme Court to recover its standing with the public.



Figure 2.2.4: Dred Scott. Source: Photo courtesy of the Missouri Historical Society, [Wikipedia Dred Scott \[en.Wikipedia.org\]](https://en.wikipedia.org/wiki/Dred_Scott).

Judicial review means that any federal court can hold any act of the president or Congress to be unconstitutional. It is a power that rests with each of the more than eight hundred federal judges, from the trial courts through the appellate courts. It is an extraordinary power in a democracy, as an unelected life-tenured person or group of persons overturns the acts of a popularly elected branch of government. Rather than give rise to judicial tyranny, however, our system of checks and balances ensures that the other two branches also play a critical role in "checking" the judiciary.

Take, for example, the executive branch. The president can control the judiciary by making careful judicial selections. The power of the president to name federal judges is absolute—he is not required to consult with any other individual in making his choice. As a matter of custom, presidents have traditionally looked to senators to provide names of judicial candidates for consideration, and some presidents are more willing than others to defer to the advice of aides and advisors. For much of the nation's history, the Senate routinely confirmed the president's choices. President Reagan's nomination of Robert Bork in 1987 changed that tradition forever. Alarmed Democrats grilled Bork in confirmation hearings and ultimately declined to confirm him, setting the stage for a new breed of confirmation hearings where senators try to ascertain not just the nominee's character but also how he or she will judge certain issues. Judicial nominees, especially to the Supreme Court, are under so much scrutiny now that sometimes even the president's own party will turn against a nominee. This happened to President George W. Bush when he named his close friend Harriet Miers to fill a vacancy left by Justice Sandra Day O'Connor's retirement. Alarmed at her lack of judicial experience and record on conservative judicial issues, Republicans urged the president to reconsider his choice, and Ms. Miers eventually withdrew as a nominee.

Presidents hope and believe that their selections reflect their own ideologies and beliefs. Federal judges are notoriously independent, however, and many demonstrate little hesitance to overrule their nominating president if they believe it necessary to do so. Several presidents have been disappointed in their nominee as they watched the judge move away from his or her earlier political roots. For example, President Eisenhower, a Republican, nominated Earl Warren as chief justice. Warren would later transform the civil rights landscape with a series of decisions, leading Eisenhower to describe nominating Warren as “the biggest damned fool mistake I ever made.” John Fox, “[Biographies of the Robes: Earl Warren](#),” PBS, December 2006. President Nixon, a Republican, placed Harry Blackmun on the Supreme Court, only to see Blackmun later move to the left and author *Roe v. Wade*, 410 U.S. 113 (1973). The principal decision legalizing access to abortion services. More recently, President George H. W. Bush nominated David Souter to the Court on the belief that Souter would be a reliable conservative. Souter quickly aligned himself with the liberal wing of the Court.

In addition to nominating judges, the president serves as a check on the judiciary by being the primary means of enforcing judicial decisions. Federal judges do not control any police force and, as such, are unable to ensure their decisions are carried out. That responsibility falls on the executive branch. No matter how much a president may disagree with a judicial decision, it is a testament to our republican form of government and the rule of law that the president nonetheless faithfully executes a federal court’s decision.

Learn More: The Little Rock Nine

[NPR - Little Rock Nine](#) [www.npr.org]



Figure 2.2.5: Elizabeth Eckford. Source: Photo courtesy of Will Counts, [Wikipedia Little Rock](#) [[en.Wikipedia.org](https://en.wikipedia.org)].

After the Supreme Court handed down its seminal decision in *Brown v. Board of Education*, *Brown v. Board of Education*, 347 U.S. 483 (1954), many Southern states continued to resist desegregation. In Little Rock, Arkansas, the local NAACP chapter enrolled nine students in Little Rock Central High School to begin the fall term in September 1957. Several segregationist groups protested, and Arkansas Governor Orval Faubus deployed Arkansas National Guard troops to stop the students from entering the school. President Eisenhower reluctantly ordered the 101st Airborne Division of the U.S. Army to Little Rock to ensure the students could enroll and attend class. Click the link to listen to a story about one of the students, Elizabeth Eckford, who tried to enroll in Little Rock Central High School that day.

The Congress can also play an important role in “checking” the judiciary. The most obvious role is in confirming judicial selections. In the last few years, judicial confirmations have become a political battlefield, as activists on both the left and right seek to block judicial nominees they view as being too radical. It’s not unusual for some judicial candidates to wait years for their confirmation hearings. President George W. Bush, for example, initially appointed Chief Justice Roberts to a court of appeals judgeship in 2001, but he wasn’t confirmed until 2003, after Republicans regained control of Congress in the midterm elections. Similarly, the newest member of the Supreme Court, Elena Kagan, was nominated for a federal appellate judgeship in 1999 by President Bill Clinton but was never confirmed due to Republican objections to her nomination.

In addition to confirmation, Congress also controls the judiciary through its annual budgetary process. Although the Constitution protects judicial salaries from any reductions, Congress is not obligated to grant any raises. For several years, judges have worked without cost-of-living raises. Although no one has seriously suggested that Congress is withholding money from the courts in

retaliation for judicial decisions, some have observed that Congress would like to see the judicial branch yield on some high-profile issues, such as televising Supreme Court proceedings in return for pay raise consideration.

Finally, Congress can control the judiciary by determining how the courts are organized and what kind of cases the courts can hear. After the 1800 presidential election, for example, the newly elected Congress canceled the Supreme Court's term for the entire year while they reorganized the judiciary. More recently, several conservative members of Congress have suggested splitting up the liberal-leaning Ninth Circuit Court of Appeals on the West Coast to reduce its influence. The Constitution also gives Congress the authority to determine the courts' jurisdiction. Congress has used this authority in the past to take away controversial cases from judicial consideration. During Civil War Reconstruction, for example, Congress passed a law taking away the Supreme Court's jurisdiction to hear an appeal from a newspaper publisher jailed for publishing articles opposing Reconstruction. *Ex parte McCordle*, 74 U.S. 506 (1869). Recently, Congress did the same thing, removing federal court jurisdiction from hearing appeals involving detainees held at the military prison in Guantanamo Bay. In the recent past, members of Congress have also introduced legislation prohibiting federal courts from hearing cases about the public display of religion and flag burning or from using any foreign law as support for their decisions.

Key Takeaways

The third branch (judicial branch) is the only unelected branch of government. As such, it can sometimes appear remote or detached from the American public. The judiciary is composed of federal courts, the Administrative Office, the Federal Judicial Center, and the U.S. Sentencing Commission. The chief justice has administrative responsibilities over these agencies in addition to his adjudicatory duties. The judiciary comprises less than two-tenths of 1 percent of the federal budget. In spite of this, judicial pay is very low compared to pay in the private sector and is a source of tension between the judiciary and the other branches of government. *Marbury v. Madison* established the doctrine of judicial review, which allows courts to determine the final validity of laws as well as the meaning of the Constitution. Judicial review is an awesome power, and it is used sparingly. The president can check the judiciary through appointments and the enforcement of judicial decisions. The Congress can check the judiciary through funding, administrative control of court calendars and funds, and jurisdiction-stripping legislation.

? Exercise 2.2.1

1. Do you believe that judicial review is a good thing for American democracy? Why or why not?
2. How does the Constitution guarantee judicial independence? Do you think judges have enough independence? Too much?
3. How much money do you think federal judges should be paid?
4. Do you believe that Congress should have the ability to remove cases from federal courts? If so, what types of cases are appropriate for removal?
5. What options does a president have if he disagrees with a federal court's opinion?
6. Should a federal court force desegregation on a community that is overwhelmingly against it?

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2.3: Guardians of the Constitution - Competing Judicial Philosophies

Learning Objectives

- Explore the strict constructionist, or originalist, judicial philosophy.
- Explore the judicial activist philosophy.
- Learn about the modern origin of the divide between these two philosophies.
- Examine the evolution of the right to privacy and how it affects judicial philosophy.
- Explore the biographies of the current Supreme Court justices.

In the early years of the republic, judges tended to be much more political than they are today. Many were former statesmen or diplomats and considered being a judge to be a mere extension of their political activities. Consider, for example, the presidential election of 1800 between John Adams and Thomas Jefferson. Even by today's heated standards of presidential politics, the 1800 election was bitter and partisan. When Jefferson won, he was in a position of being president at a time when not a single federal judge in the country came from his political party. Jefferson was extremely wary of judges, and when the Supreme Court handed down the *Marbury v. Madison* decision in 1803, declaring the Supreme Court the ultimate interpreter of the Constitution's meaning, Jefferson wrote that "to consider the judges as the ultimate arbiters of all constitutional questions is a very dangerous doctrine indeed, and one which would place us under the despotism of an oligarchy." Thomas Jefferson to William C. Jarvis, 1820, in *The Writings of Thomas Jefferson*, ed. Andrew A. Lipscomb and Albert Ellery Bergh, Memorial Edition (Washington, DC: Thomas Jefferson Memorial Association of the United States, 1903–4), 15:277, quoted in Eyler Robert Coates Sr., "18. Judicial Review," *Thomas Jefferson on Politics & Government: Quotations from the Writings of Thomas Jefferson*, 1999. A few years later, the first justice to be impeached, Samuel Chase, was accused of being overly political. His impeachment (and subsequent acquittal) started a trend toward nonpartisanship and political impartiality among judges. Today, judges continue this tradition by exercising impartiality in cases before them. Nonetheless, charges of political bias continue to be levied against judges at all levels.

In truth, the majority of a judge's work has nothing to do with politics. Even at the Supreme Court level, most of the cases heard involve conflicts among circuit courts of appeals or statutory interpretation. In a small minority of cases, however, federal judges are called on to interpret a case involving religion, race, or civil rights. In these cases, judges are guided sometimes by nothing more than their own interpretation of case law and their own conscience. This has led some activists to claim that judges are using their positions to advance their own political agendas.

In general terms, judges are thought to fall into one of two ideological camps. On the politically conservative right, judges are described as either strict constructionists or originalists. Judges who adhere to this philosophy believe that social change is best left to the politically elected branches of government. The role of judges is therefore to strictly interpret the Constitution, and nothing more. Strict constructionists also believe that the Constitution contains the complete list of rights that Americans enjoy and that any right not listed in the Constitution does not exist and must be earned legislatively or through constitutional amendment. Judges do not have the power to "invent" a new right that does not exist in the Constitution. These judges believe in original meaning, which means interpreting the Constitution as it was meant when it was written, as opposed to how society would interpret the Constitution today. Strict constructionists believe that interpreting new rights into the Constitution is a dangerous exercise because there is nothing to guide the development of new rights other than a judge's individual conscience. Justice Clarence Thomas, appointed in 1991, is a great example of an originalist because he looks at the original meaning of the Constitution's words, like in his dissents about the Second Amendment right to bear arms. Justice Samuel Alito, joining in 2006, mostly agrees with this approach but sometimes takes a more practical view when applying it to cases. This follows the idea that the Constitution's original meaning should guide judges, but it doesn't always control every decision completely.

Learn More: Clarence Thomas

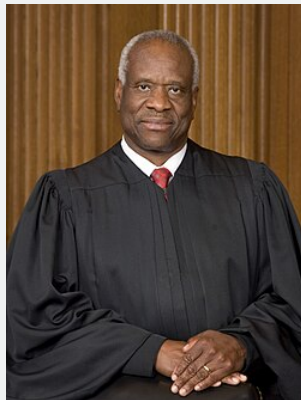


Figure 2.3.1: Justice Clarence Thomas, 2007. Source: Photo courtesy of Steve Petteway, Collection of the Supreme Court of the United States, [Wikipedia \[en.wikipedia.org\]](https://en.wikipedia.org)

In celebration of the 225th anniversary of the U.S. Constitution (2012), Justice Clarence Thomas and Yale Law School Professor Akhil Amar discussed the Constitution's past, present, and future. The program titled "The Constitution Turns 225" was held in the William G. McGowan Theater in the National Archives Building. [C-Span \[www.c-span.org\]](http://www.c-span.org)

On the politically liberal left are judges who are described as activist. Judicial activists believe that judges have a role in shaping a “more perfect union” as described in the Constitution and that, therefore, judges have the obligation to seek justice whenever possible. They believe that the Constitution is a “living document” and should be interpreted in light of society’s needs, rather than its historical meaning. Judicial activists believe that sometimes the political process is flawed and that majority rule can lead to the baser instincts of humanity becoming the rule of law. They believe their role is to safeguard the voice of the minority and the oppressed and to deliver the promise of liberty in the Constitution to all Americans. Judicial activists believe in a broad reading of the Constitution, preferring to look at the motivation, intent, and implications of the Constitution’s safeguards rather than merely its words. Judicial activism at the Supreme Court was at its peak in the 1960s, when Chief Justice Earl Warren led the Court in breaking new ground on civil rights protections. Although a Republican and nominated by Republican President Eisenhower, Earl Warren became a far more activist judge than anyone anticipated once on the Supreme Court. Chief Justice Warren led the Court in the desegregation cases in the 1950s, including the one affecting the Little Rock Nine. The “Miranda” *Miranda v. Arizona*, 384 U.S. 436 (1969). warnings—familiar to nearly every American who has ever seen a police show or movie—come from Chief Justice Warren, as does the fact that anyone who cannot afford an attorney has the right to publicly funded counsel in most criminal cases.



Figure 2.3.2: President Franklin Roosevelt. Source: Photo courtesy of the [U.S. Library of Congress](https://www.loc.gov).

The modern characterization of judges as politically motivated can be traced to the Great Depression. Against cataclysmic economic upheaval, Americans voted for Franklin D. Roosevelt (Figure 2.3.2 "President Franklin Roosevelt") in record numbers, and they delivered commanding majorities in both the Senate and House of Representatives to his Democratic Party. President Roosevelt vowed to alter the relationship between the people and their government to prevent the sort of destruction and despair wreaked by the Depression. The centerpiece of his action plan was the New Deal, a legislative package that rewrote the role of

government, vastly increasing its size and its role in private commercial activity. The New Deal brought maximum working hours, the minimum wage, mortgage assistance, economic stimulus, and social safety nets such as Social Security and insured bank deposits. Although the White House and Congress were in near-complete agreement on the New Deal, the Supreme Court was controlled by a slim majority known as the “Four Horsemen of the Apocalypse” because of their dire warnings of the consequences of economic regulation. Three justices known as the “Three Musketeers”—Justice Brandeis, Justice Cardozo, and Justice Stone—opposed the Four Horsemen. In the middle sat two swing votes. The Four Horsemen initially prevailed, and one by one, pieces of President Roosevelt’s New Deal were struck down as unconstitutional reaches of power by the federal government. Frustrated, President Roosevelt devised a plan to alter the makeup of the Supreme Court by increasing the number of judges and appointing new justices. The “court-packing plan” was never implemented due to the public’s reaction, but nonetheless, the swing votes on the Supreme Court switched their votes and began upholding New Deal legislation, leading some historians to label their move the “switch in time that saved Nine.” During the public debate over the Supreme Court’s decisions on the New Deal, the justices came under constant attack for being politically motivated. The loudest criticism came from the White House.

Learn More: Fireside Chats

[Fireside Chats](https://millercenter.org/fireside-chats) [millercenter.org]

One of the hallmarks of FDR’s presidency was his use of the radio to reach millions of Americans across the country. He regularly broadcast his “fireside chats” to inform and lobby the public. In this link, President Roosevelt complains bitterly about the Supreme Court, claiming that “the Court has been acting not as a judicial body, but as a policy-making body.” Do modern politicians make the same accusation?

The abortion debate is a good example of the politically charged atmosphere surrounding modern judicial politics. Strict constructionists decry *Roe v. Wade* as an extremely activist decision and bemoan the fact that in a democracy, no one has ever had the chance to vote on one of the most socially controversial and divisive issues of our time. *Roe* held that a woman has a right to privacy and that her right to privacy must be balanced against the government’s interest in preserving human life. Within the first trimester of her pregnancy, her right to privacy outweighs governmental intrusion. Since there is no right to privacy mentioned in the Constitution, strict constructionists believe that *Roe* has no constitutional foundation to stand on.

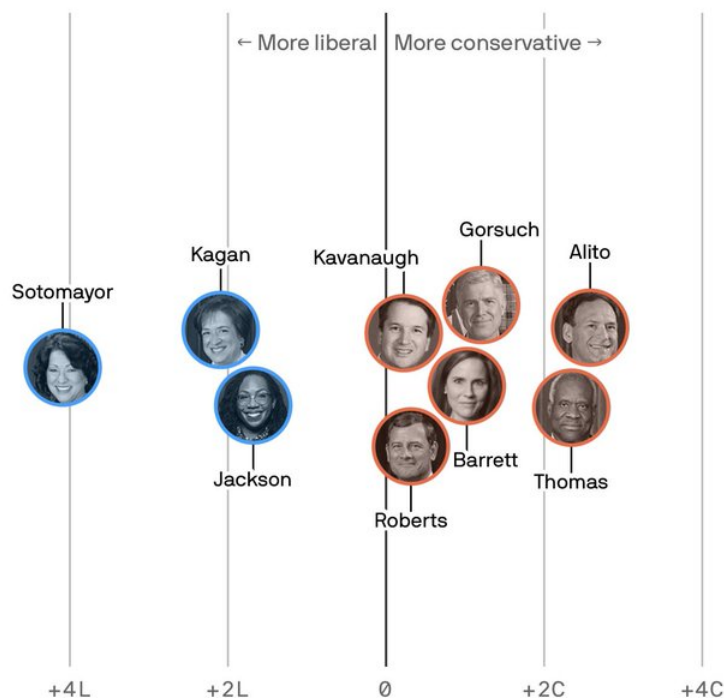
Roe did not, however, declare that a right to privacy exists in the Constitution. A string of cases before *Roe* established that right. In 1965, the Supreme Court overturned a Connecticut law prohibiting unmarried couples from purchasing any form of birth control or contraceptive. *Griswold v. Connecticut*, 381 U.S. 479 (1965). The Court reasoned that the First Amendment has a “penumbra of privacy” that must include the right for couples to choose if and when they want to have children. Two years later, the Supreme Court found a right to privacy in the due process clause when it declared laws prohibiting mixed-race marriages to be unconstitutional. *Loving v. Virginia*, 388 U.S. 1 (1967). As a result of these decisions and others like them, the phrase “right to privacy” today is widely accepted as a form of litmus test for whether a judge (or judicial candidate) is a strict constructionist or activist.

In 2022, the Supreme Court case *Dobbs v. Jackson Women's Health Organization* overturned *Roe v. Wade*, ending the nationwide right to abortion that *Roe* had created in 1973. The Court, in a 6-3 vote led by Justice Alito, upheld a Mississippi law banning most abortions after 15 weeks. The justices said the Constitution doesn't mention abortion or protect it as a fundamental right, based on America's history and traditions. States had long regulated abortion since the 1800s. They argued *Roe*'s "viability" rule (no bans before a fetus could live outside the womb) wasn't in the Constitution's text and caused problems, so states should handle these rules through voting and laws on health and morals.

Estimated ideologies of Supreme Court justices

Preliminary Martin-Quinn scores for 2022-23 term

Nominating president was a ● Democrat ● Republican



Data: [Martin-Quinn scores](#); Chart: Simran Parwani/Axios

Figure 2.3.3: Estimated ideologies of Supreme Court Justices/Axios. Martin-Quinn scores measure the ideological leanings of U.S. Supreme Court justices based on their voting patterns, with negative values indicating liberal tendencies and positive values conservative ones. These dynamic scores, developed by Andrew Martin and Kevin Quinn, track justices from the 1937 term onward and are widely used in legal analysis. A key visual resource is a comprehensive graph plotting all justices' scores over time. Chart: Simran Parwaini/Axios

Since federal judges are appointed for life, the Supreme Court rarely sees turnover. The Court had no changes for eleven years until recent years brought several new justices, including three women among the current four female justices: Sonia Sotomayor, Elena Kagan, Amy Coney Barrett, and Ketanji Brown Jackson. George W. Bush first nominated John Roberts in 2005 to replace Sandra Day O'Connor; after Chief Justice William Rehnquist's death, Roberts became Chief Justice. Harriet Miers withdrew amid conservative pushback over her lack of judicial experience, paving the way for Samuel Alito, whose reliable conservatism shifted the Court rightward. In the last 15 years, key appointments include Neil Gorsuch (2017, replacing Antonin Scalia), Brett Kavanaugh (2018, replacing Anthony Kennedy), Amy Coney Barrett (2020, replacing Ruth Bader Ginsburg), and Ketanji Brown Jackson (2022, replacing Stephen Breyer). Earlier, Barack Obama nominated Sonia Sotomayor (2009, replacing David Souter) and Elena Kagan (2010, replacing John Paul Stevens), seen as centrist picks. Today's nine-member Court reflects a 6-3 conservative majority.

Learn More: Biographies of the Current Supreme Court Justices

[Biographies](#) [www.supremecourt.gov]

The Supreme Court today is more diverse than it ever has been throughout its history. The hardworking men and women of the Court command respect from the legal community both in the United States and abroad. Click the link to explore their biographies.

Key Takeaways

Judicial conservatives, also known as originalists or strict constructionists, believe that the Constitution should be interpreted strictly, in light of its original meaning when it was written. They believe that societal change, especially the creation of new civil rights, should come from the political process rather than the judicial process. Judicial liberals, also known as judicial activists, believe that judges have a role to play in shaping a more perfect union. They believe that the outcome of a case is paramount over other considerations, including past precedent. Judicial activists are more likely to find new civil rights in the Constitution, which they believe should be broadly interpreted in light of modern society's needs. The modern fight over judicial conservatives and judicial liberals began with FDR's New Deal and his court-packing plan and continues to this day. The right to privacy is a good example of the difference between judicial conservatives and judicial liberals, and it is seen as a test to determine what philosophy a judge subscribes to. After a long period of stability, membership in the Supreme Court changed substantially since 2016 with five new members: Neil Gorsuch (replacing Antonin Scalia), Brett Kavanaugh (replacing Anthony Kennedy), Amy Coney Barrett (replacing Ruth Bader Ginsburg), and Ketanji Brown Jackson (replacing Stephen Breyer). The Court now holds a solid 6-3 conservative majority, giving conservatives firm control over its direction, without a key swing vote like Anthony Kennedy.

? Exercise 2.3.1

1. Read [Justice Stewart's dissent in the *Griswold* case](#). Although he believes Connecticut's law is "uncommonly silly," he nonetheless believes that it's not unconstitutional. Do you think that judges have an obligation to overturn "uncommonly silly" laws?
2. Modern judicial confirmation hearings have been described as an intricate dance between nominees and Senators, with the nominees giving broad, scripted answers that reveal little about their actual judicial philosophy. Do you agree with this characterization? Do you think any changes should be made to the confirmation process?
3. If you were president, what characteristics would you look for in nominating federal judges?
4. If an elected legislature refuses to grant citizens a right to privacy, do you believe it is appropriate for the courts to do so? Why or why not?
5. If a president believes that the Court has reached the wrong result, should the president be able to change the Court by increasing its numbers or forcing early retirement?

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2.4: Trial and Appellate Courts

Learning Objectives

- Learn the differences between the state and federal constitutions.
- Understand subject matter jurisdiction.
- Explore the state and federal court systems.
- Distinguish the work of trial and appellate courts.

In many American cities, you can find both a state and a federal courthouse. These courts hear different types of cases, involving different laws, different law enforcement agencies, and different judicial systems. The rules governing the procedures used in these courts are known as civil procedure or criminal procedure and are sometimes so hard to understand that they confound experienced attorneys and judges. Nonetheless, as future business professionals, it's important for you to understand the general boundaries between state and federal courts.

Most people forget that there are actually fifty-one separate legal systems in the United States: one federal and fifty in the states. Within each legal system is a complex interplay among executive, legislative, and judicial branches of government. The foundation of each of these systems of government is a constitution. Some state constitutions are actually older than the federal Constitution, while others are relatively new. The Massachusetts Constitution, for example, was ratified in 1780, seven years before the federal Constitution. The Montana Constitution, on the other hand, was adopted in 1972. In some states, state constitutions remain vibrant and provide civil protections beyond the federal Constitution. Several state Supreme Courts, for example, have interpreted their various state constitutions as prohibiting treating gays and lesbians differently when it comes to marriage under their “equal protection” provisions. Other state supreme courts have interpreted their state constitutions to grant citizens the right to choose the time and manner of their own death. Since these decisions are made by state supreme courts interpreting their own state constitutions, they are beyond the reach or review of the federal Congress or federal courts. This dynamic power-sharing between state and federal governments is known as federalism and is a key feature of our republican form of government.

To determine which court a case belongs in, lawyers look first to what the case is about. The rules of subject matter jurisdiction dictate whether a case is heard in federal or state court. Lawsuits involving state laws are generally heard in state courts. Most criminal laws, for example, are state laws. There may be wide differences among the states about what behavior constitutes criminal behavior. Speed limits, for example, are different from state to state. Even serious crimes such as murder or manslaughter, and possible defenses to those crimes, are defined differently by the states. Domestic issues such as divorce and family law are also handled at the state level. Some states make it very easy to marry (Nevada provides an obvious example), while others define marriage differently. Child custody and adoption laws are state-based. Property and probate laws are also based on state law. Laws related to the transfer of property (including real estate), vehicle or watercraft ownership registration, and the disposition of property after death are different depending on the state you live in. The laws surrounding contracts are also passed at the state level (although most are based on a common law called the Uniform Commercial Code [UCC]). Finally, the law of torts is state-based. Torts are any civil wrong other than a breach of contract and can cover a vast array of situations in which people and businesses suffer legal injury. Some states are far friendlier toward torts than others, and the resulting patchwork of tort laws means that companies that do business across the country need to bear in mind the different standards they are held to, based on what state their customers live in.

Given the wide array of subject areas regulated by state law, it's not surprising that for most individuals and businesses, their experience with courts is with state courts. Nonetheless, cases do sometimes end up in federal court as well. Federal court subject matter jurisdiction is generally limited to cases involving a federal question—either the federal Constitution or a federal law. Cases involving the interpretation of treaties to which the United States is a party are also subject to federal court jurisdiction. In fact, any case involving the United States as a party is properly litigated in federal court. Finally, in original jurisdiction cases (so-called because the Constitution specifically grants this jurisdiction), lawsuits between states can be filed directly with the U.S. Supreme Court. Ongoing disputes between Wyoming and Montana over the use of the Tongue and Powder rivers, for example, were litigated in the Supreme Court in 2005.

Recently, nationwide injunctions have become quite prevalent. Nationwide injunctions are court orders issued by a single federal district judge that prohibit the enforcement of a federal law, regulation, or executive policy across the entire United States, not just for the specific plaintiffs in the case. Rooted in equity powers under the Judiciary Act of 1789 and the Administrative Procedure Act, they aim to provide complete relief by vacating unlawful agency actions nationwide, but critics decry them as judicial overreach that enables forum-shopping and bypasses appellate review. These injunctions surged in use during the Obama and Trump administrations, with over 60 issued against Trump's first-term policies on immigration (e.g., the travel ban), DACA rescission, and transgender military service, often from a handful of districts.

In the Trump administration's second term, starting in 2025, district courts swiftly issued universal injunctions against executive orders on border security and federal spending cuts, prompting emergency Supreme Court appeals. The pivotal case, *Trump v. CASA, Inc.* (June 27, 2025), saw a 6-3 ruling limiting such injunctions, holding that federal courts lack authority under historical equity principles to bind the government beyond the plaintiffs, thus curbing "judge-shopping" while allowing narrower or class-wide relief. This decision resolved tensions from earlier blocks on Trump's policies, emphasizing circuit-by-circuit development of the law.

Sometimes it's possible for a federal court to hear a case involving a state law. These cases are called diversity jurisdiction cases, and they arise when all plaintiffs in a civil case are from different states than all defendants and the amount claimed by the plaintiffs exceeds seventy-five thousand dollars. Diversity jurisdiction cases allow one party who feels it may not receive a fair trial where its opponent has a "home court" advantage to seek a more neutral forum to hear its case, a process called removal.

Within both the federal court and the state court system, there is a hierarchy of higher and lower courts. The diagram in Figure 2.4.1 "State and Federal Court Systems" demonstrates this hierarchy. The U.S. Supreme Court is the highest court in the country, and all courts are bound to follow precedent established by the U.S. Supreme Court through the doctrine of stare decisis. Keep in mind, though, that if an issue is exclusively a state matter (such as a state court interpreting its own state's Constitution), then the U.S. Supreme Court has no jurisdiction on that matter, leaving the state supreme court as the highest court on that particular issue.

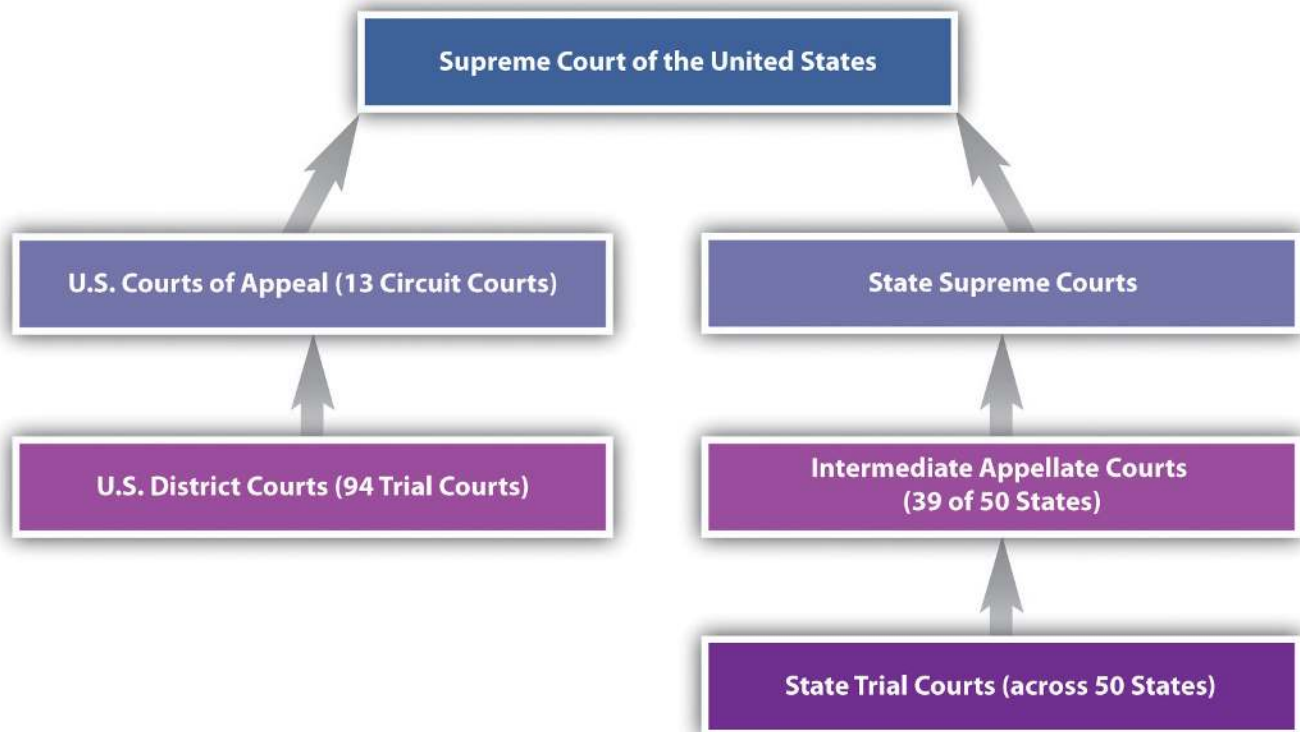


Figure 2.4.1: State and Federal Court Systems

On the left-hand side of the diagram is the federal court system. Cases are filed in a U.S. District Court, the trial court in the federal system. Under the court administration system, there are ninety-four judicial districts in the country. Some states with low populations have only one judicial district, while more populous states have multiple judicial districts. The districts are named for

their geographical location—the federal court in Manhattan, for example, is the U.S. District Court for the Southern District of New York. The U.S. Department of Justice, which acts as the prosecutor representing the federal government in both civil and criminal cases, divides its attorneys among the ninety-four judicial districts, with each district led by a U.S. attorney appointed by the president without any Senate confirmation.

As a trial court, the U.S. district courts hear civil and criminal trials. The trials may be bench trials (heard only by the judge) or they may be jury trials. At the trial, witnesses are called, and their testimonies are recorded, word for word, into a trial record (transcript of what was said in the courtroom along with supporting documentation). At the conclusion of the trial, if the losing side is unhappy with the outcome, it is entitled as a matter of right to appeal its case to the U.S. Circuit Court of Appeals. There are thirteen circuit courts of appeals in the United States, also spread geographically through the states. A party losing an appeal at the circuit court level can appeal one more time to the U.S. Supreme Court for review, but given the extremely small odds of that appeal being granted, most federal litigation ends at the U.S. circuit court level.

On the right side of the diagram is the state court system. In all fifty states, a trial court of general jurisdiction accepts most types of civil and criminal cases. These courts are called various names, such as superior court, circuit court, or district court. Confusingly, trial courts in New York State are called supreme courts. There may be other courts of limited jurisdiction at the state level, such as traffic court, juvenile court, family court, or small claims court. Increasingly, states are also experimenting with specialized drug courts to treat drug abuse (not distribution or trafficking) as a health problem rather than a criminal problem. State judges may be either appointed by the governor or elected by the public. Like their federal counterparts, state trial courts hold trials, and most preserve a trial record for review by an appellate court. In thirty-nine states, a party that loses at trial can file an appeal with an intermediate court of appeals. The remaining states are smaller and therefore don't maintain this level of appeal, in which case appeals are filed directly with the state supreme court. In states with an intermediate court of appeals, the party losing the appeal can typically file one more time with the state supreme court, although state supreme court rules vary on whether appeals are a matter of right or discretion. Finally, in certain cases that involve a federal constitutional right, a party that loses at the state supreme court level can appeal to the U.S. Supreme Court for review. These cases are typically criminal and involve the application of the Constitution to criminal procedure, evidence collection, or punishment.

Whenever an appeal is filed, the trial record is forwarded to the appellate court for review. Appellate courts do not conduct new trials and are unable to recall witnesses or call new witnesses. The trial court's duty is to figure out the facts of the case—who did what, when, why, or how. This process of fact-finding is an important part of the judicial process, and a great deal of deference is placed on the judgment of the fact finder (trier of fact). The trier of fact is typically the jury, or the judge in the case of a bench trial. On appeal, the appellate judge cannot substitute his or her interpretation of the facts for that of the trier of fact, even if the appellate judge believes the trier of fact was wrong. The issues on appeal are, therefore, limited to questions of law or legal errors. For example, the appellate court may disagree with the trial judge's interpretation of the meaning of a law, or it may disagree with a ruling the trial judge made about what evidence should be admitted or excluded to the trier of fact.

The deference to the trier of fact (trial court) means that, as a practical matter, appeals are rarely won. Even if a litigant is successful in persuading a court of appeals that legal error has taken place, it doesn't automatically win the case. In most cases, the best remedy a litigant can hope for is for the court of appeals to send the case back to a trial court (a process called remand) for reconsideration or perhaps a new trial.

Key Takeaways

There are fifty-one separate legal systems in the United States, each with its own executive, legislative, and judicial functions. State constitutions remain a vibrant source of civil rights protections for many citizens because state constitutions are permitted to grant more civil rights (but not fewer) than the federal Constitution. Subject matter jurisdiction is the authority of a court to hear a case based on its subject matter. State law claims are generally heard in state courts, while federal question cases are generally heard in federal court. Federal courts sometimes hear state law claims under diversity jurisdiction. Federal cases are filed in a U.S. district court and appealed to a U.S. circuit court of appeals. State cases are typically filed in a trial court and appealed to an intermediate court of appeals. The U.S. Supreme Court is the highest court in the country, and all other courts must follow the precedent in Supreme Court opinions. Trial courts are the triers of fact, and their judgment is not questioned by appellate courts. Appellate court review is limited to legal errors.

? Exercise 2.4.1

1. Do you think that the “home court advantage” that justifies diversity jurisdiction still exists? Why or why not?
2. Should states retain the ability to grant more civil rights than the federal Constitution? Can you think of historical examples of this happening? What implications does this have for the future?
3. Stare decisis requires courts to respect and follow established precedent. Why do you think stare decisis is important in our common-law system? What do you think would happen if courts were not bound to stare decisis?
4. Under what circumstances do you think the Supreme Court should feel comfortable abandoning a prior precedent? Do you think the answer differs depending on whether you believe in judicial originalism or activism?

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2.5: Introduction to Alternative Dispute Resolution

Learning Objectives

After reading this chapter, you should understand alternative dispute resolution (ADR) options, including the benefits and drawbacks of different methods of dispute resolution. You will know the legal basis for mandatory arbitration, as well as why parties enter into voluntary ADR methods. You will understand current debates regarding the fairness of ADR. Additionally, you should be able to answer the following questions:

- What are the benefits and drawbacks of ADR as compared to litigation?
- What legal basis supports the use of ADR rather than litigation?
- What unique challenges exist in ADR efforts among B2B (business-to-business), B2C (business-to-consumer), and B2E (business-to-employees)?
- What are the ethical implications of ADR between parties that are unequal in power?

Imagine that you've been wronged by a supplier, by your employer, or by a business where you are a customer. You've correctly determined that you have an actionable legal claim. What are you going to do? You probably *won't* run to the courthouse to file a formal complaint to initiate litigation. This is because litigation is very expensive and time-consuming. Besides, you may wish to continue doing business with the supplier, employer, or business. Perhaps the matter is of a private nature, and you do not want to engage in a public process to determine the outcome. You would like the dispute to be resolved, but you do not want to engage in public, time-consuming, expensive litigation to do it.

A common method of dispute resolution that avoids many of the challenges associated with litigation is alternative dispute resolution. Alternative dispute resolution (ADR) is a term that encompasses many different methods of dispute resolution *other than* litigation. ADR involves resolving disputes outside of the judicial process, though the judiciary can require parties to participate in specific types of ADR, such as arbitration, for some types of conflicts. Moreover, some ADR methods vest power to resolve the dispute in a neutral party, while other strategies vest that power in the parties themselves. See Figure 2.5.1 "A Continuum of Different ADR Methods" for a continuum of different ADR methods based on where power to solve the dispute is vested.

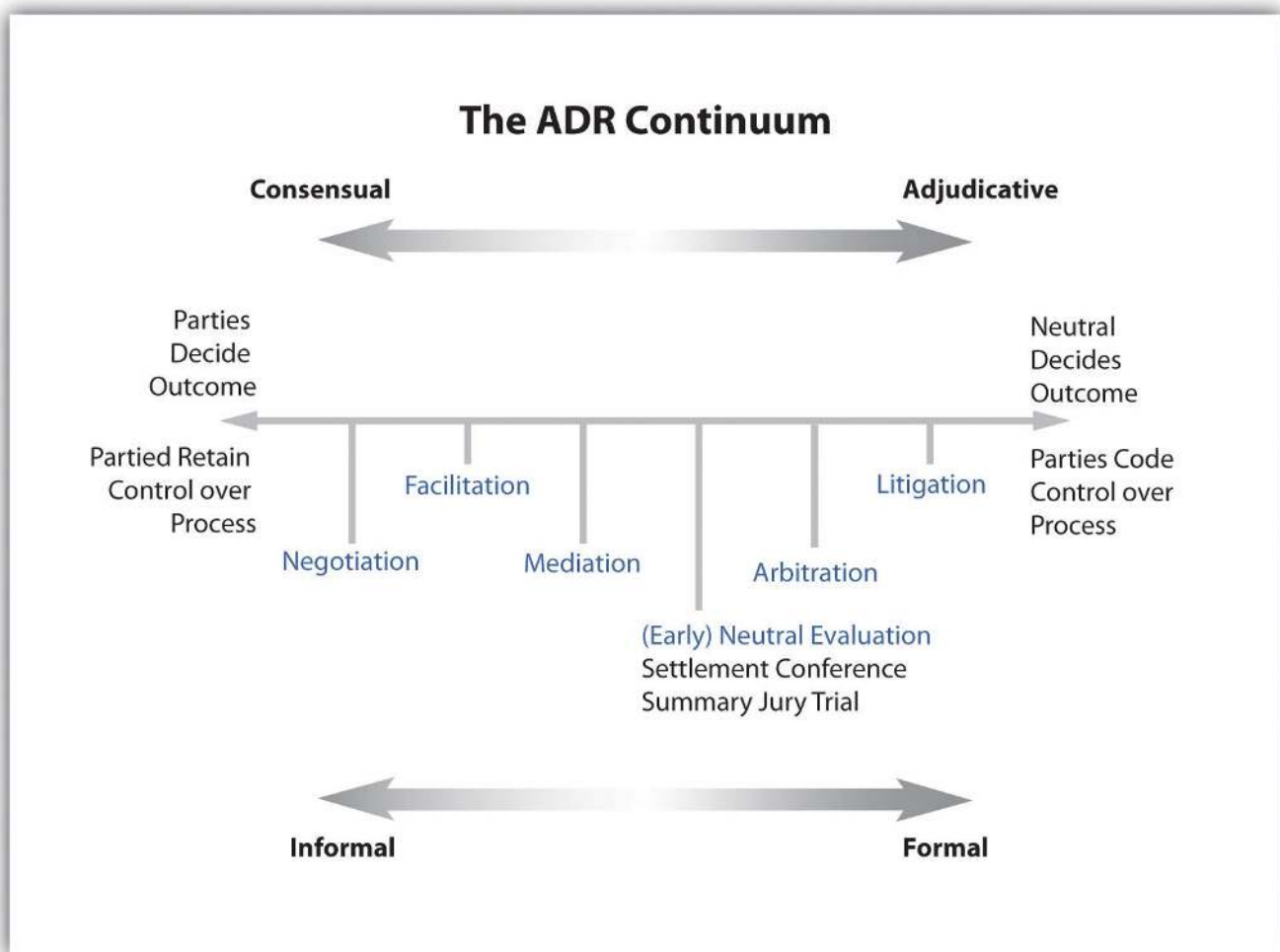


Figure 2.5.1: A Continuum of Different ADR Methods. Source: Adapted from New York State Unified Court System, www.nycourts.gov/ip/adr/images/continuum2.jpg.

Common methods of ADR include negotiation, mediation, and arbitration. Lesser-used methods of ADR include minitrials, hybrid forms of mediation-arbitration (with elements of both), and collaborative goal-oriented processes. ADR is often used to resolve disputes among businesses, employers and employees, and businesses and consumers. ADR can also be used in many other types of conflicts. For instance, ADR strategies can be used in domestic law cases, such as divorce, or in international legal issues, such as issues relating to transboundary pollution. This chapter limits its focus to the use of ADR methods in business. Particularly, we will examine the common methods of ADR, including the benefits and drawbacks of each. We will also examine potential consequences to parties that have unequal bargaining power. Additionally, we will examine the use of ADR methods in situations where ADR may not be the most appropriate method of dispute resolution, such as civil rights violations.

ADR methods are used outside of the courtroom, but that does not mean that they are outside of the interests of our legal system. Participation in ADR has important legal consequences. For instance, parties that have agreed by contract to be subject to binding arbitration give up their constitutional right to bring their complaint to court. The Federal Arbitration Act (FAA) is a federal statute under which parties are required to participate in arbitration when they have agreed by contract to do so, even in state court matters. Indeed, the FAA is a national policy favoring arbitration. *Southland Corp. v. Keating*, 465 U.S. 1 (1984). The *Southland Corp.* Court said that “in enacting...[the FAA], Congress declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration.” This is an example of federal preemption exercised through the Supremacy Clause in the U.S. Constitution.

There is a very good chance that you will—or already have—signed a contract that contains a mandatory arbitration clause. This means that if a dispute arises under that contract, then you will be required to arbitrate your claim rather than going straight to

court. Under a binding arbitration clause, you will have waived your constitutional rights to go to court. Even if you have never signed such a contract and never will, there is still a good likelihood that you will be involved in a commercial dispute at some point in your life. Because of this, it's important to understand the ADR process, situations in which litigation is a better choice than ADR, and special issues that arise when parties have unequal bargaining power.

Key Takeaways

Alternative dispute resolution (ADR) is a body of dispute-resolution methods outside of the litigation process. ADR is often faster, less expensive, and more private than litigation. For this reason, ADR can be the preferred dispute-resolution method, particularly when an ongoing relationship between disputants is desired. However, some types of disputes might be best resolved through litigation, such as in cases where parties have unequal power or resources or in civil rights violations. Common methods of dispute resolution are negotiation, mediation, and arbitration. Mandatory arbitration clauses are common in contracts, and such clauses are enforceable against the parties even if they wish to litigate their claims.

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2.6: Negotiation

Learning Objectives

- Understand the role of negotiation in avoiding and settling disputes.
- Explore negotiation as it is commonly employed in business.
- Understand the implications of bargaining power during negotiation.
- Become familiar with the benefits and drawbacks of negotiation as a form of alternative dispute resolution (ADR).

Imagine that you are a tent manufacturer. Your supplier of tent fabric routinely supplies you with appropriate water-resistant fabric to construct your tents, so that you can produce your products and bring them to market. After many years of a good working relationship, your fabric supplier delivered nonconforming goods. Specifically, the fabric delivered was not water-resistant, despite your need for water-resistant fabric to produce your tents. However, on your notifying the supplier of the problem, the supplier denied that the fabric was nonconforming to your order. You refused to pay for the goods. The fabric supplier insisted on payment before future delivery of any additional fabric. Without water-resistant fabric, you cannot continue to produce your tents.

This is an example of a business-to-business (B2B) dispute. Despite the problem, you will likely wish to continue working with this supplier, since you have a good, long-standing relationship with it. This problem seems to be a “hiccup” in your regular business relationship. Accordingly, you will probably want to resolve this dispute quickly and without hard feelings. It is very unlikely that you will immediately hire an attorney to file a formal complaint against your supplier. However, that does not change the fact that there is a dispute that needs to be resolved.

One of the first strategies that you and your supplier are likely to employ is negotiation. Negotiation is a method of alternative dispute resolution (ADR) that retains the power to resolve the dispute for the parties involved. No outside party is vested with authoritative decision-making power concerning the resolution of the dispute. Negotiation requires the parties to define the conflicts and agree to an outcome to resolve those conflicts. Often, this can take the form of a compromise. Note that a compromise does not mean that anyone “loses.” Indeed, if both parties are satisfied with the result of the negotiation and the business relationship can continue moving forward, then both parties will be very likely to consider this as a “winning” situation.

Benefits to negotiation as a method of ADR include its potential for a speedy resolution, the inexpensive nature of participation, and the fact that parties participate voluntarily. Drawbacks include the fact that there are no set rules, and either party may bargain badly or even unethically if they choose to do so. In a negotiation, there is no neutral party charged with ensuring that rules are followed, that the negotiation strategy is fair, or that the overall outcome is sound. Moreover, any party can walk away whenever it wishes. There is no guarantee of resolution through this method. The result may not be “win-win” or “win-lose,” but no resolution at all. Also, generally speaking, attorneys are not involved in many negotiations. This last point may be seen as a drawback or a benefit, depending on the circumstances of the negotiation.

Though our example involves B2B, the parties may or may not have equal bargaining power. If your business and your supplier are both dependent on each other for roughly equal portions of the respective businesses, then they are most likely relatively equal with respect to bargaining power. However, in our example, if your business is a very small business but your supplier is a very large business—perhaps with a patent protecting the rights to the specialty fabric that you need—then we might say that the B2B negotiation is potentially unbalanced, since one party has a much more powerful bargaining position than the other. Specifically, your business needs that particular type of fabric, which is only available from one supplier. But your supplier does not need your business because it has a legal monopoly in the form of a patent for its product, and it probably sells to many manufacturers. This would be an example of unequal bargaining power.

When the negotiation occurs as a result of a dispute, but not a legal dispute per se, then the party with the weakest bargaining position may be in a very vulnerable spot. This is illustrated in “Learn More: Rubbermaid’s Unequal Bargaining Power”. When Rubbermaid’s raw materials price for resin increased, it needed to raise its prices. However, Wal-Mart refused to accept the necessary price increase for Rubbermaid products. This refusal had a substantial negative impact on Rubbermaid’s business, since Wal-Mart was its main customer. In short, Rubbermaid needed Wal-Mart, but Wal-Mart did not need Rubbermaid.

Learn More: Rubbermaid's Unequal Bargaining Power

A Question of Ethics

Watch “[Muscling Manufacturers](#),” a clip from *Is Wal-Mart Good for America?* to see how unequal bargaining power can affect the least powerful party in a negotiation.

As economist Brink Lindsey from the Cato Institute commented, “We’ve definitely seen a shift in the balance of bargaining power between manufacturers and retailers...Back in the old days, manufacturing was a high-productivity endeavor; retailing and distribution were fairly low-productivity...And so manufacturers called the shots.” Hedrick Smith, “[Who Calls the Shots in the Global Economy?](#)” PBS, November 16, 2004.

That doesn’t appear to be the case anymore.

Negotiation is a skill often developed by people who are charged with settling existing disputes or with creating new agreements. Since we are focusing on dispute resolution in this chapter, we will limit our discussion to the resolution of disputes rather than the negotiation of new contract terms, but keep in mind that these activities essentially draw on the same skills.

In *Getting to Yes*, written by members of the Harvard Program on Negotiation, the goal of negotiation is viewed as “win-win.” Roger Fisher, William Ury, and Bruce Patton, *Getting to Yes* (New York: Penguin Books, 1991). Note that this is a substantially different goal from litigation. Our adversarial legal system requires one party to “win” and the other party to “lose.” *Getting to Yes* focuses on principled negotiation, and it sets forth specific steps and discusses strategies to allow participants to achieve the “win-win” goal. This book’s popularity perhaps suggests that people have a real interest in learning about ADR, avoiding litigation, and ensuring that all parties leave the resolution process as “winners.” Some concepts common in negotiation include the BATNA, WATNA, and the bargaining zone. For example, the authors of *Getting to Yes* encourage negotiators to know their best alternative to a negotiated agreement (BATNA). This ensures that unfavorable terms will not be accepted, and terms consistent with a negotiator’s interests won’t be rejected. Roger Fisher, William Ury, and Bruce Patton, *Getting to Yes* (New York: Penguin Books, 1991), 100. Likewise, the worst alternative to a negotiated agreement (WATNA) is a concept used by some negotiators prior to entering negotiations. The bargaining zone is the area in which parties to a negotiation are willing to trade, barter, or negotiate their positions, within which parties can find an acceptable agreement. If you think of a Venn diagram, the bargaining zone would be where the two ovals overlap. The reservation point is essentially a party’s “bottom line,” beyond which it will not agree to terms.

Let’s go back to our example. Imagine that after negotiating with your fabric supplier, the following facts emerged: The fabric supplier believed that it sent the correct fabric to you, because one of your new employees inadvertently ordered the wrong fabric. You reviewed your business records and determined that this allegation was true. This sounds like a misunderstanding that would be easy to clear up in negotiation, doesn’t it? Imagine the embarrassment and hard feelings that would have been caused by immediately filing a formal complaint in court, not to mention the great expense that both parties would have incurred. Through negotiation, chances are very good that this misunderstanding will be resolved in a win-win outcome and that you will be able to continue your working relationship with your supplier.

Key Takeaways

Negotiation is a method of alternative dispute resolution (ADR) in which the parties retain power to decide on a resolution of the issue themselves, without relying on a neutral decision maker. Negotiation is also used between parties entering into agreements, when there is no legal dispute. Negotiation is often the first method of dispute resolution attempted, because it is inexpensive and relatively fast. Additionally, parties that wish to continue working together in the future often employ negotiation as a friendly method to resolve disputes. Negotiation between parties with unequal bargaining power can result in the stronger party being heavy-handed at the negotiation table, which can result in unfair outcomes for the weaker party. Since negotiation does not follow an externally imposed set of rules, parties may negotiate as their conscience dictates. However, negotiation is often considered a dispute-resolution option that can result in a win-win situation for all parties, as illustrated by the popular book *Getting to Yes*, in which negotiation strategies are set forth in detail.

? Exercise 2.6.1

1. What are the benefits of negotiation as a dispute-resolution method? What are the drawbacks?
2. How can parties that have unequal bargaining power negotiate meaningfully, without one party taking advantage of the other? Have you ever negotiated with someone who had more bargaining power than you? What were your strategies during the negotiation? Did you obtain your goal by the conclusion of the negotiation?
3. Watch the video in "Learn More: Rubbermaid's Unequal Bargaining Power" (Muscling Manufacturers). If you were a manufacturer and you had to raise prices due to an increase in price for your raw materials, and if Wal-Mart was your most important customer, what strategies would you employ so that both parties would have a chance to have a "win-win" outcome?

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2.7: Mediation

Learning Objectives

- Learn what mediation is.
- Explore the process of mediation as an alternative dispute resolution (ADR) strategy.
- Identify disputes suitable for mediation as a form of ADR.
- Become familiar with the benefits and drawbacks of mediation as a form of ADR.

Mediation is a method of ADR in which parties work to form a mutually acceptable agreement. Like negotiation, parties in mediation do not vest authority to decide the dispute in a neutral third party. Instead, this authority remains with the parties themselves, who are free to terminate mediation if they believe it is not working. Often, when parties terminate mediation, they pursue another form of ADR, such as arbitration, or they choose to litigate their claims in court. Mediation is appropriate only for parties who are willing to participate in the process. Like negotiation, mediation seeks a “win-win” outcome for the parties involved. Additionally, mediation is confidential, which can be an attractive attribute for people who wish to avoid the public nature of litigation. The mediation process is usually much faster than litigation, and the associated costs can be substantially less than those of litigation.

Unlike in many negotiations, a third party is involved in mediation. Indeed, a neutral mediator is crucial to the mediation process. Mediators act as a go-between for the parties, seeking to facilitate the agreement. There are no uniform licensing requirements, but some states require specific training or qualifications for a person to be certified as a mediator. Mediators do not provide advice on the subject matter of the dispute. In fact, the mediators may not possess any subject-matter expertise concerning the nature of the dispute. However, many mediators are trained in conflict resolution, and this allows them to employ methods to discover common goals or objectives, set aside issues that are not relevant, and facilitate an agreement into which the parties will voluntarily enter. Mediators try to find common ground by identifying common goals or objectives and by asking parties to set aside the sometimes emotionally laden obstacles that are not relevant to the sought-after agreement itself.

Disputants choose their mediator. This choice is often made based on the mediator’s reputation as a skilled conflict resolution expert, professional background, training, experience, cost, and availability. After a mediator is chosen, the parties prepare for mediation. For instance, prior to the mediation process, the mediator typically asks the parties to sign a mediation agreement. This agreement may embody the parties’ commitments to proceed in good faith, understanding of the voluntary nature of the process, commitments to confidentiality, and recognition of the mediator’s role of neutrality rather than one of legal counsel. At the outset, the mediator typically explains the process that the mediation will follow. The parties then proceed according to that plan, which may include opening statements, face-to-face communication, or indirect communication through the mediator. The mediator may suggest options for resolution and, depending on his or her skill, may be able to suggest alternatives not previously considered by the disputants.

Mediation is often an option for parties who cannot negotiate with each other but who could reach a mutually beneficial or mutually acceptable resolution with the assistance of a neutral party to help sort out the issues and find a resolution that achieves the parties’ objectives. Sometimes parties in mediation retain attorneys, but this is not required. If parties do retain counsel, their costs for participating in the mediation will obviously increase.

In business, mediation is often the method of ADR used in disputes between employers and employees about topics such as workplace conditions, wrongful discharge, or advancement grievances. Mediation is used in disputes between businesses, such as in contract disputes. Mediation is also used for disputes arising between businesses and consumers, such as in medical malpractice cases or health care disputes.

Like other forms of dispute resolution, mediation has benefits and drawbacks. The benefits are many. They include the relative expediency of reaching a resolution, the reduced costs as compared to litigation, the ability for parties that are unable to communicate with each other to resolve their dispute using a non-adversarial process, the imposition of rules on the process by the mediator to keep parties “within bounds” of the process, confidentiality, and the voluntary nature of participation. Of course, the potential for a “win-win” outcome is a benefit. Attorneys may or may not be involved, and this can be viewed as either a benefit or a drawback, depending on the circumstances.

Drawbacks to mediation also exist. For example, if disputants are not willing to participate in the mediation process, the mediation will not work. This is because mediation requires voluntary participation between willing parties to reach a mutually agreeable resolution. Additionally, even after considerable effort by the parties in dispute, the mediation may fail. This means that the resolution of the problem may have to be postponed until another form of ADR is used, or until the parties litigate their case in court. Since mediators are individuals, they have different levels of expertise in conflict resolution, and they possess different backgrounds and worldviews that might influence the manner in which they conduct mediation. Parties may be satisfied with one mediator but not satisfied in subsequent mediations with a different mediator. Even if an agreement is reached, the mediation itself is usually not binding. Parties can later become dissatisfied with the agreement reached during mediation and choose to pursue the dispute through other ADR methods or through litigation. For this reason, parties often enter into a legally binding contract that embodies the terms of the resolution of the mediation immediately on conclusion of the successful mediation. Therefore, the terms of the mediation can become binding if they are reduced to such a contract, and some parties may find this to be disadvantageous to their interests. Of course, any party that signs such an agreement would do so voluntarily. However, in some cases, if legal counsel is not involved, parties may not fully understand the implications of the agreement that they are signing.

Key Takeaways

Mediation is a method of ADR in which the parties retain power to decide the issue themselves without vesting that power in an outside decision-maker. However, mediation relies on neutral mediators who facilitate the mediation process to assist the parties in achieving an acceptable, voluntary agreement. Mediation is more formal than negotiation but less formal than arbitration or litigation. Mediation is relatively inexpensive, fast, and confidential, unlike litigation. Though nonbinding mediation resolutions are not binding on the parties, these resolution agreements may be incorporated into a legally binding contract, which is binding on the parties who execute the contract. Mediation does not follow a uniform set of rules, though mediators typically set forth rules that the mediation will observe at the outset of the process. Successful mediation often reflects not only the parties' willingness to participate but also the mediator's skill. There is no uniform set of rules for mediators to become licensed, and rules vary by state regarding requirements for mediator certification.

? Exercise 2.7.1

1. Find your state's requirements and qualifications for mediators. What would it take for you to become a mediator in your state? Do you think that your state requirements ensure that only qualified mediators practice? Why or why not?
2. Identify a situation in which you would choose mediation as your preferred method of dispute resolution. Why is mediation the best method in this situation? What are the potential benefits and drawbacks of mediation in this situation?
3. Should mediators be required to be licensed, like attorneys or physicians, before practicing? Why or why not?

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2.8: Arbitration

Learning Objectives

- Explore the option of arbitration as an alternative dispute resolution (ADR) strategy.
- Explore contemporary issues of fairness in arbitration.
- Determine when arbitration is a viable option for dispute resolution.
- Examine the benefits and drawbacks of arbitration as a form of ADR.

Arbitration is a method of ADR in which parties vest authority in a third-party neutral decision-maker who will hear their case and issue a decision, which is called an arbitration award.

An arbitrator presides over arbitration proceedings. Arbitrators are neutral decision-makers who are often experts in the law and subject matter at issue in the dispute. Their decisions do not form binding precedent. Arbitrators may be members of the judiciary, but in arbitrations, they are not judges. Arbitrators act in an analogous capacity to judges in trials. For instance, they determine which evidence can be introduced, hear the parties' cases, and issue decisions. They may be certified by the state in which they arbitrate, and they may arbitrate only certain types of claims. For instance, the Better Business Bureau trains its own arbitrators to hear common complaints between businesses and consumers (B2C).

Participation in the arbitration proceeding is sometimes mandatory. Mandatory arbitration results when disputes arise out of a legally binding contract involving commerce in which the parties agreed to submit to mandatory arbitration. Arbitration is also mandatory when state law requires parties to enter into mandatory arbitration.

Although perhaps not obvious, federal law lies at the heart of mandatory arbitration clauses in contracts. Specifically, Congress enacted the Federal Arbitration Act (FAA) 9 U.S.C. §1 et seq. through its Commerce Clause powers. This act requires parties to engage in arbitration when those parties have entered into legally binding contracts with a mandatory arbitration clause, providing the subject of those contracts involves commerce. 9 U.S.C. §2. In *Southland Park v. Keating*, the U.S. Supreme Court interpreted this federal statute to apply to matters of both federal and state court jurisdiction. Indeed, the Court held that the FAA created a national policy in favor of arbitration. It also held that the FAA preempts state power to create a judicial forum for disputes arising under contracts with mandatory arbitration clauses. *Southland Corp. v. Keating*, 465 U.S. 1 (1984). In a later decision, the Court held that the FAA encompasses transactions within the broadest permissible exercise of congressional power under the Commerce Clause. *Citizens Bank v. Alafabco, Inc.*, 539 U.S. 52 (2003). This means that the FAA requires mandatory arbitration clauses to be enforceable for virtually any transaction involving interstate commerce, very broadly construed.

Some states require mandatory arbitration for certain types of disputes. For instance, in Oregon, the state courts require mandatory arbitration for civil suits where the prayer for damages is less than \$50,000, excluding attorney fees and costs. ORS 36.405. Many parties accept the arbitration award without appeal. However, when state law requires mandatory arbitration of certain types of disputes, parties are permitted to appeal because the arbitration is nonbinding. In nonbinding arbitration, the parties may choose to resolve their dispute through litigation if the arbitration award is rejected by a party. However, some states have statutory requirements that, in practice, create a chilling effect on appealing an arbitration award. For example, in the state of Washington, if the appealing party from a nonbinding mandatory arbitration does not do better at trial than the original award issued by the arbitrator, then that party will incur liability not only for its own expenses but also for those of the opposing side. Washington State Court Rules of Procedure, Superior Court Mandatory Arbitration Rules 7.3. In nonbinding arbitration, this is a powerful incentive for parties to accept the arbitration award without appealing to the judicial system.

Voluntary arbitration also exists, and it is frequently used in business disputes. Sometimes parties simply agree that they do not want to litigate a dispute because they believe that the benefits of arbitration outweigh the costs of litigation, so they choose voluntary arbitration in hopes of a speedy and relatively inexpensive outcome. Other times, parties are not certain how strong their case is. In such cases, arbitration can seem much more attractive than litigation.

Arbitration awards can be binding or nonbinding. Some states, like Washington State, have codified the rule that arbitration decisions are binding when parties voluntarily submit to the arbitration procedure. Uniform Arbitration Act, RCW 7.04. In binding arbitration, the arbitration award is final; therefore, appealing an arbitration award to the judicial system is not available. In many states, an arbitration award is converted to a judgment by the court, thereby creating the legal mechanism through which the

judgment holder can pursue collection activities. This process, called confirmation, is contemplated by the FAA and often included in arbitration agreements. But even if the FAA does not apply, most states have enacted versions of either the Uniform Arbitration Act or the Revised Uniform Arbitration Act. These state laws allow confirmation of arbitration awards into judgments as well.

Like any other form of dispute resolution, arbitration has certain benefits and drawbacks. Arbitration is an adversarial process like a trial, and it will produce a “winner” and a “loser.” Arbitration is more formal than negotiation and mediation, and, in many ways, it resembles a trial. Parties present their cases to the arbitrator by introducing evidence. After both sides have presented their cases, the arbitrator issues an arbitration award.

Rules related to arbitration differ by state. The rules of procedure that apply to litigation in a trial do not typically apply to arbitration. Specifically, the rules are often less formal or less restrictive on the presentation of evidence and the arbitration procedure. Arbitrators decide which evidence to allow, and they are not required to follow precedents or to provide their reasoning in the final award. In short, arbitrations adhere to rules, but those rules are not the same as the rules of procedure for litigation. Regardless of which rules are followed, arbitrations proceed under a set of external rules known to all parties involved in any given arbitration.

Arbitration can be more expensive than negotiation or mediation, but it is often less expensive than litigation. In *Circuit City Stores Inc. v. Adams*, the U.S. Supreme Court noted that avoiding the cost of litigation was a real benefit of arbitration. *Circuit City Stores, Inc., v. Adams*, 532 U.S. 105 (2001). The costly discovery phase of a trial is nonexistent or sharply reduced in arbitration. However, arbitration is not necessarily inexpensive. Parties must bear the costs of the arbitrator, and they typically retain counsel to represent them. Additionally, in mandatory arbitration clause cases, the arbitration may be required to take place in a distant city from one of the disputants. This means that the party will have to pay travel costs and associated expenses during the arbitration proceeding. The *Circuit City* Court also noted that mandatory arbitration clauses avoid difficult choice-of-law problems that litigants often face, particularly in employment law cases.

Arbitration is faster than litigation, but it is not as private as negotiation or mediation. Unlike mediators, arbitrators are often subject-matter experts in the legal area of dispute. However, as is true for mediators, much depends on the arbitrator’s skill and judgment.

A common issue that arises is whether mandatory arbitration is fair in certain circumstances. It’s easy to imagine that arbitration is fair when both parties are equally situated. For example, business-to-business (B2B) arbitrations are often perceived as fair, especially if businesses are roughly the same size or have roughly equal bargaining power. This is because they will be able to devote approximately the same amount of resources to dispute resolution, and they both understand the subject under dispute, whatever the commercial issue may be. Moreover, in B2B disputes, the subjects of disputes are commercial issues, which may not implicate deeper social and ethical questions. For example, contract disputes between businesses might involve whether goods are conforming goods or nonconforming goods under the Uniform Commercial Code (UCC). No powerful social or ethical questions arise in such disputes. Indeed, resolving such disputes might be seen as “business as usual” to many commercial enterprises.

However, issues of fairness often arise in business-to-employee (B2E) and business-to-consumer (B2C) situations, particularly where parties with unequal bargaining power have entered into a contract that contains a mandatory arbitration clause. In such cases, the weaker party has no real negotiating power to modify or to delete the mandatory arbitration clause, so that party is required to agree to such a clause if it wants to engage in certain types of transactions. For example, almost all credit card contracts contain mandatory arbitration clauses. This means that if a consumer wishes to have a credit card account, he will agree to waive his constitutional rights to a trial by signing the credit card contract. As we know, the FAA will require parties to adhere to the mandatory arbitration agreed to in such a contract, in the event that a dispute arises under that contract. In such cases, questions regarding whether consent was actually given may legitimately be raised. However, the U.S. Supreme Court has held that in B2E contexts, unequal bargaining power alone is not a sufficient reason to hold that arbitration agreements are unenforceable, *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991). and it is not sufficient to preclude arbitration. *Lozano v. AT & T Wireless*, 504 F.3d 718 (9th Cir. 2007).

Additionally, concerns about fairness do not end at contract formation. If a dispute arises and mandatory arbitration is commenced, the unequal power between the parties will continue to be an important issue. In the case between a credit card company and an average consumer debtor, the credit card company would clearly be in a more powerful position vis-à-vis the debtor by virtue of the company’s financial strength and all that comes with it, such as experienced attorneys on staff, dispute-resolution experience,

and contractual terms that favor it, rather than the consumer debtor. In such cases, if the consumer debtor is the aggrieved party, he may very well decide to drop the matter, especially if the arbitration clause requires arbitration proceedings to occur in a distant city. The credit card company will have vast financial resources as compared to the consumer debtor. Moreover, in this example, the credit card company's legal counsel will know how to navigate the arbitration process and will have experience in dispute resolution, processes that often confound people who are not trained in law. Additionally, the list of arbitrators may include people who are dependent on repeat business from the credit card company for their own livelihoods, thereby creating—or at least suggesting—an inherent conflict of interest. Many mandatory arbitration clauses create binding awards on one party while reserving the right to bring a claim in court to the other party. That is, a mandatory arbitration clause may allow the credit card company to appeal an arbitrator's award, but to render an award binding on the consumer debtor. Obviously, this would allow the credit card company to appeal an unfavorable ruling, while requiring the consumer debtor to abide by an arbitrator's unfavorable ruling. To a consumer debtor, the arbitration experience can seem like a game played on the credit card company's home court—daunting, feckless, and intimidating.

Additionally, some types of disputes that have been subjected to mandatory arbitration raise serious questions about the appropriateness of ADR, due to the nature of the underlying dispute. For example, in some recent B2E disputes, claims relating to sexual assault have been subjected to mandatory arbitration when the employee signed an employment contract with a mandatory arbitration clause. Tracy Barker, for example, was reportedly sexually assaulted by a State Department employee in Iraq while she was employed as a civilian contractor by KBR Inc., a former Halliburton subsidiary. When she tried to bring her claim in court, the judge dismissed the claim, citing the mandatory arbitration clause in her employment contract. After arbitration, she won a three-million-dollar arbitration award. As KBR Inc. noted, this “decision validates what KBR has maintained all along; that the arbitration process is truly neutral and works in the best interest of the parties involved.” Despite this statement, KBR Inc. has filed a motion to modify the award. Juan A. Lozano, “[Woman Awarded \\$3M in Assault Claim against KBR](#),” *AP News*, November 19, 2009.

In a similar case, employee Jamie Leigh Jones worked for KBR Inc. in Iraq when she was drugged and gang raped. She was initially prohibited from suing KBR Inc. in court because her employment contract contained a mandatory arbitration clause. However, when considering this case, the Fifth Circuit Court of Appeals ruled that sexual assault cases may, in fact, be brought in court rather than being subjected to mandatory arbitration, despite the contract language requiring mandatory arbitration. *Jones v. Halliburton Co.*, 583 F.3d 228 (5th Cir. 2009). Jones's claims were beyond the scope of the arbitration clause, because sexual assault is not within the scope of employment. Moreover, under Senator Al Franken's lead, the Senate took action to prohibit the Department of Defense from contracting with defense contractors that require mandatory arbitration for sexual assault claims. If such action is passed, it would essentially allow the Fifth Circuit's holding to apply in all federal jurisdictions rather than just in the Fifth Circuit. One might think that passing such a law would be a “no-brainer” to lawmakers. However, some Senators voted against the measure, arguing that the federal government should not insert itself into rewriting contracts. Instead, some argued that the use of arbitration and mediation should be expanded for such cases.

In B2C cases, different issues of fairness exist. As noted previously, when the disputants possess unequal power, these issues can be magnified. Public Citizen, a nonprofit organization that represents consumer interests in Congress, released a report concerning arbitration in B2C disputes. Specifically, the report argued that arbitration is unfair to consumers in B2C disputes and that consumers fare better in litigation than in arbitration. According to the report, incentives exist to favor businesses over consumers in the arbitration process. It pointed to the lack of appeal rights, lack of requirement to follow precedents or established law, limits on consumers' remedies, prohibitions against class-action suits, limitations on access to jury trials, limitations on abilities to collect evidence, and greater expense as additional factors speaking to the unfairness of arbitration over litigation in B2C disputes. Check out “Learn More: Arbitration” for the full report.

Learn More: Arbitration

Check out the Public Citizen report, [The Arbitration Debate Trap: How Opponents of Corporate Accountability Distort the Debate on Arbitration](#), which argues that arbitration is bad for consumers in B2C disputes.

Importantly, and despite the FAA's broad interpretation, not all binding arbitration clauses have been upheld by courts in B2C cases. In 2007, the Ninth Circuit Court of Appeals ruled that AT&T's binding arbitration clause for wireless customers is

unenforceable under California state law. *Lozano v. AT & T Wireless*, 504 F.3d 718 (9th Cir. 2007). The court further noted that the relevant state law is not preempted by the FAA, because the FAA does not prevent the courts from applying state law. In this case, that law involved the unconscionability of contract terms. As noted previously, the FAA requires parties to submit to mandatory arbitration when they agree to do so in a legally binding contract, and it preempts state powers to provide a judicial forum in those matters. However, the Ninth Circuit's holding in this case underscores the fact that state contract law is not circumvented by the federal statute.

Arbitration is a widely used form of ADR, but important questions have been raised about its appropriateness in certain types of disputes. Before signing a mandatory arbitration agreement, it's important to realize that under current law, your opportunity to bring your claim in court will be severely restricted or entirely precluded. Moreover, if you sign such an agreement with a party that holds inherently greater power than you, such as your employer, then you may find yourself at an extreme disadvantage in an arbitration proceeding.

Key Takeaways

Arbitration is a form of ADR in which parties vest authority to decide a dispute with a third-party arbitrator, who hears the evidence and issues an arbitration award. Arbitration may be binding or nonbinding, and it may be mandatory or voluntary. Arbitration awards issued by arbitrators can be confirmed to judgments by judges. Issues of fairness arise in arbitration when disputants possess unequal power, such as in employment or consumer disputes. Questions concerning the appropriateness of mandatory arbitration arise in cases involving issues of civil rights violations. The Federal Arbitration Act requires the enforcement of mandatory arbitration clauses in contract disputes involving commerce where mandatory arbitration clauses exist. The Arbitration Fairness Act of 2009 would resolve several issues of unfairness, but this act has not yet been passed into law.

? Exercise 2.8.1

1. In the *Barker v. Halliburton Inc.* case, does the three-million-dollar arbitration award in favor of the sexual assault victim prove that arbitration works, even in violations of civil rights disputes? Why or why not?
2. Choose one argument in *The Arbitration Debate Trap: How Opponents of Corporate Accountability Distort the Debate on Arbitration* in "Learn More: Arbitration" and develop a counterargument to support the contention that arbitration is good in B2C disputes. Compare your argument with the argument in the report. Which side is the most persuasive? After completing this exercise, do you believe that arbitration is good or bad for consumers in B2C disputes? Why?
3. Bank of America announced that it would no longer require mandatory arbitration in disputes arising between it and consumer credit card account holders. Review the story here: <http://www.reuters.com/article/idUSTRE57D03E20090814>. What are the benefits and drawbacks to Bank of America's credit card account customers with respect to this change?
4. In what contexts have you entered into an arbitration agreement (e.g., home purchase, credit card agreement, cell phone agreement)? Write a short essay discussing the implications of entering into that agreement.

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2.9: Inside the Courtroom - Procedures and Practice

Learning Objectives

In this section, you will explore our litigation system in detail. Litigation provides an opportunity for each side in a dispute, whether criminal or civil, to lay their side of the story to an impartial jury or judge and ask that jury or judge to decide who wins and loses, and how much the loser should pay or how much time the defendant should spend in jail. After reading this section, you should have a deeper understanding of how litigation is conducted in the United States. Specifically, you should be able to answer the following questions:

- Who are the parties involved in litigation?
- What is standing, and how does it impact litigation?
- How does a court obtain personal jurisdiction over a defendant?
- How does a trial progress from beginning to end?
- How does a losing side appeal a case?

Even if you've never stepped foot in a courtroom before, you can probably describe what a courtroom looks like. It's a large, imposing room with tall ceilings, flags on stands, and wood paneling on the walls. The majority of the floor space is taken up with seating for the public. The front of the courtroom is dominated by the bench, behind which the judge sits, above everyone else in the room. Next to the bench is a solitary chair with a microphone in front of it, where a witness sits. Along one side of the wall is a separated area with two rows of seats, where the jury sits. Facing the bench, and always closest to the jury, is one table for the party that is carrying the burden of proof in the case: the prosecution in a criminal trial and the plaintiff in a civil trial. Across the aisle, there is another impressive table for the opposite side, the defense. When the court is in session, a hush settles into the room so that everyone can hear the judge, commanding in presence, or the witness, captivating in detail.

Many of us have such clear imagery of a courtroom because our experiences are drawn from popular culture. Whether in movies (*A Civil Action*, *To Kill a Mockingbird*, *Erin Brockovich*), on television shows (*Law & Order*, *L.A. Law*, *Boston Legal*), or in fictional books (*The Firm*, *Twelve Angry Men*), courtroom scenes capture our imagination and fire our sense of righteousness and justice as good always prevails over evil. In our collective courtrooms, the truth always comes out, our ideals are always upheld, and the bad guys always lose. Who could forget, for example, the psychological breakdown on the witness stand in the movie *A Few Good Men*, as Jack Nicholson plays it out?

You Can't Handle the Truth

Courtroom scenes in movies, while providing wonderful imagery, are pure fiction. In a real courtroom, there is no back-and-forth argument between counsel and witness as examinations proceed through questioning alone. In a real courtroom, the truth doesn't always emerge. In a real courtroom, there are many shades of gray between good and evil. And finally, in a real courtroom, the bad guys don't always lose, and the good guys don't always win.

As future business professionals, your responsibility to your company, to your company's stakeholders, and to yourself is to avoid ever seeing the inside of a courtroom. Acting ethically and legally, and identifying the legal pitfalls that you may encounter by mastering the elements of this course, will help you achieve this goal. Agreeing to arbitration for parties with whom you have a preexisting relationship, such as your customers, suppliers, or employees, will also help you stay away from a courtroom. In spite of this planning, however, many companies still find that litigation is sometimes unavoidable. Whether litigation is initiated against parties you don't have a contract with (such as another company that steals your intellectual property rights) or by parties you don't have a contract with (such as a customer who is injured by your product or an employee harassed by another employee), litigation may be the only dispute-resolution mechanism available.

In this section, we'll explore the process of litigation from the beginning to the end. You'll learn about the parties involved and about preliminary matters such as standing and personal jurisdiction, and then explore the trial and appeal. We'll also discuss the role of lawyers and juries in our litigation system. By the end of the section, you'll have an appreciation that while our litigation system is cherished for its ability to resolve disputes peacefully and establish a hallmark for public accessibility, for businesses, it is often a far from satisfactory forum for dispute resolution.

Key Takeaways

Litigation is an inevitable part of a business's activities. Lawsuits, trials, and appeals can be ruinously expensive for some companies, especially small- and medium-sized enterprises. Learning about our litigation system will give you the skills and comfort you need should your company find itself in litigation.

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2.10: The Parties Involved

Learning Objectives

- Identify the parties involved in litigation.
- Explore the role of lawyers in our adversarial system.
- Understand the roles and obligations of jurors.

The litigation system relies on parties bringing forth and defending their respective claims. As in the game of chess, each move can take place only if a player makes a decision to move in a particular direction; the game does not play itself. Courts, jurors, and witnesses are similarly moribund: it is up to the players, in this case called litigants, to act decisively. Occasionally, a court may act *sua sponte*, without a direct request from a party. A judge may decide, for example, to fine a party for bad or unethical behavior. These actions are fairly rare. More commonly, judges act on a motion filed by either party asking the judge to make a particular decision.

The party that begins the lawsuit is called the plaintiff in a civil case. The plaintiff is a victim who has presumably suffered some sort of legal wrong that the law recognizes. The plaintiff brings suit against the defendant, the alleged wrongdoer or perpetrator. Note that in a criminal trial, the party that initiates litigation is the prosecution, representing the people of a state or, in federal cases, representing the people of the United States. In a criminal trial, the alleged wrongdoer is also called the defendant.

Many cases involve multiple plaintiffs and multiple defendants. Civil procedure encourages, and makes it easy for, parties to air all their grievances against each other at once. All parties, and every possible claim (each claim is a separate violation of law) arising out of a single incident or series of related incidents, should be identified and named in a lawsuit. For example, if you go to an off-campus party one night and witness a friend being harassed, you might feel the need to step in to defend your friend. The harasser may then turn his attention toward you, perhaps taking a swing at you. Let's assume that the harasser is drunk and misses, but in return, you take a swing and hit him, knocking him to the ground. The harasser may file a lawsuit against you, alleging assault and battery. The harasser is the plaintiff, and you are the defendant. The lawsuit filed in court would be captioned *Harasser v. You*. You might decide in return to file a claim against the harasser, alleging that the harasser started the fight and that you acted in self-defense. This is called a counterclaim, and you are now the counterplaintiff, making the harasser the counterdefendant. In return, the harasser may allege that he wasn't really harassing your friend but trying to defend himself from your friend's unwanted advances. The harasser may sue your friend as a third-party defendant through a process called joinder.

Except in some small-claims courts, parties hire attorneys to litigate most cases. Sometimes individuals feel like they have a sufficient grasp on the law to proceed in litigation without a lawyer or that they have sufficient legal training (or even a law degree) that hiring a lawyer would be a waste of money. Individuals who represent themselves are called *pro se* litigants and can only proceed *pro se* if the judge overseeing the case allows it. Abraham Lincoln once famously said, "He who represents himself has a fool for a client." The complexities of litigation require a cool and detached mind to thread a route to success, and if you are representing yourself, it is all too easy to allow passion to cloud your judgment.

Attorneys are sometimes called members of the bar. The U.S. legal profession is unique in several respects. In most countries, legal education is an undergraduate program followed by a period of apprenticeship before an individual is allowed to practice law. Many countries also make a distinction between attorneys who litigate in court and those who do not. In the United Kingdom, for example, solicitors are lawyers who deal with ordinary legal matters outside of court, while Queen's Counsel (QC) are specially trained lawyers who are permitted to argue in court. In the United States, lawyers undertake three years of graduate study resulting in the award of the Juris Doctorate degree, or JD. Every year, more than thirty thousand students graduate from U.S. law schools with their JD. They then sit for the bar exam in the state where they wish to practice. Since the practice of law in the United States varies widely by different jurisdictions, lawyers are only permitted to practice in jurisdictions where they are licensed. Some states permit lawyers from out of state, after a few years of being in practice, to apply for bar admission without taking the exam through a process called reciprocity. Other states, notably California and Florida, require attorneys to take the bar exam no matter how long they have been in practice. If a lawyer is dealing with an issue or matter that takes him or her out of state to litigate a case, he or she can ask to be admitted temporarily by a court in that foreign state through a motion called *pro hac vice*. Once the lawyer passes the

state's bar exam or is otherwise admitted, he or she is permitted to practice all aspects of law in that state, from drafting wills and contracts to arguing a case before the U.S. Supreme Court.

Attorneys in the United States are broadly divided into civil and criminal attorneys; few lawyers excel in both areas. Civil attorneys generally work in two different categories: in law firms, where they may represent multiple clients, and as in-house counsel, where they represent only one client, their employer. Most large corporations have an in-house legal department to control legal costs, but may still hire outside counsel for representation and advice in complex matters.

With the possible exception of politicians, no other profession is subject to more morbid jokes than lawyering. William Shakespeare famously wrote in *Henry VI*, through a character speaking of a utopian world, "The first thing we do, let's kill all the lawyers." In spite of this public animosity toward lawyers, however, if there comes a time when someone needs a lawyer, it's not uncommon to hear them wish they had the most aggressive lawyer money can buy.

Perhaps part of the reason the public has a low opinion of lawyers can be traced to the ethical and legal obligations of attorneys. Lawyers may be the most regulated of all the professional industries, and they are required to comply with complex and sometimes rigid rules of professional conduct. Unlike rules for other professions, the rules of professional conduct for lawyers are largely drafted and enforced by the bar itself (other lawyers and judges) and almost never involve external enforcement mechanisms. These rules govern virtually every aspect of the practice of law, and a violation of these rules can result in disciplinary action from the state bar or supreme court of the state in which the lawyer practices, up to lifetime disbarment. When President Bill Clinton, for example, lied under oath about certain aspects of his extramarital affairs, he was suspended from practicing law for five years in Arkansas and ordered to pay a \$25,000 fine. These rules of professional responsibility require attorneys to represent their clients with zealous advocacy. Ordinarily, we associate the word "zealot" with extremists, but that is the standard by which lawyers must represent their clients. This might clarify why some lawyers act the way they do.

One of the most sacrosanct rules of professional responsibility is the obligation to keep a client's secrets. The communications between a client and his or her attorney are absolutely confidential under the attorney-client privilege doctrine. There are many privileges under the law, such as the spousal privilege, doctor-patient privilege, and priest-penitent privilege. The attorney-client privilege, however, is arguably the strongest of these privileges. The privilege belongs to the client, and the attorney is not permitted to reveal any of these communications without the client's consent. A narrow exception exists for clients who tell their lawyers they intend to harm others or themselves, but attorneys must tread very carefully to avoid violating the privilege. Many members of the public feel that the privilege may be open to abuse and can't understand, for example, why an attorney can't reveal a client's confession to a heinous crime. Ultimately, the privilege exists for the client's benefit. Someone who cannot communicate with his or her attorney freely is unable to help the attorney prepare the best possible case for litigation. You should note that in-house attorneys represent the corporations they work for and not individual employees. If you communicate with an in-house attorney for the company where you work, for example, that communication may not be automatically protected by the attorney-client privilege.

Learn More: The Lynne Stewart Case

[Lynne Stewart](#), a human rights attorney, was assigned to represent Sheik Omar Abdel-Rahman, the blind Egyptian cleric convicted of conspiracy in the 1993 World Trade Center bombing in New York City. As part of her representation, she agreed to abide by certain conditions when communicating with her client, including not speaking to the media. Ms. Stewart broke those promises and inadvertently passed on a communication from her client to his followers around the world. She was indicted and convicted of conspiracy and providing material support to terrorists. She was sentenced to a twenty-eight-month prison term. Click the link to read more about her case, including the legal documents involved. A very controversial aspect of the case involved the use of secret cameras and recorders to listen in on her conversations with her client while he was in prison.



Figure 2.10.1: Lynne Stewart. Source: Photo courtesy of Robert B. Livingston, [Wikipedia](https://en.wikipedia.org) [en.Wikipedia.org].

In spite of an attorney's professional obligations to his or her client, it's important to remember that ultimately a lawyer's first duty is to the administration of justice. The rules of professional conduct are written with this goal in mind. The requirements for lawyers on civility, honesty, and fairness are all written to ensure that lawyers represent the very best aspects of our judicial system. Let's say, for example, a client admits to his lawyer that he is guilty or liable in a case. The client then wants to testify under oath that he is innocent. Although a lawyer cannot tell anyone what her client has told her, the lawyer is also prohibited from knowingly suborning perjury. The attorney must either convince the client not to testify or withdraw from the case.

In the case of "A Question of Ethics", an attorney goes a little too far in her representation and draws a heavy fine from a judge as a result.

Learn More: A Question of Ethics

The Case of the Birther Attorney

Order Hon. Clay D. Land, U.S. District Judge, District Court for the Middle District of Georgia, Case No. 4:09-CV-106, [Rhodes v. MacDonald](#).

Throughout the presidential election campaign in 2008, persistent rumors swirled around whether Barack Obama was born in the United States, a requirement under the Constitution to serve as president. After the election, California attorney Orly Taitz launched a campaign to prove that the president was not, in fact, born in Hawaii. Her bizarre tirades against the media and the courts earned her this unusual reprimand from a federal judge. Click the link to read the entire order. Do you believe that in their "zealous" representation of their clients, attorneys have the ethical duty to pursue claims such as these?

Commenting on the special privilege granted to lawyers and the corresponding duty imposed on them, Justice Cardozo once observed, "Membership in the bar is a privilege burdened with conditions. [A lawyer is] received into that ancient fellowship for something more than private gain. He [becomes] an officer of the court, and, like the court itself, an instrument or agency to advance the ends of justice." Competent and ethical lawyers "are essential to the primary governmental function of administering justice." For justice to be administered efficiently and justly, lawyers must understand the conditions that govern their privilege to practice law. Lawyers who do not understand those conditions are at best woefully unprepared to practice the profession and at worst a menace to it.

When a lawyer files complaints and motions without a reasonable basis for believing that they are supported by existing law or a modification or extension of existing law, that lawyer abuses her privilege to practice law. When a lawyer uses the courts as a platform for a political agenda disconnected from any legitimate legal cause of action, that lawyer abuses her privilege to practice law. When a lawyer personally attacks opposing parties and disrespects the integrity of the judiciary, that lawyer abuses her privilege to practice law. When a lawyer recklessly accuses a judge of violating the Judicial Code of Conduct with no supporting evidence beyond her dissatisfaction with the judge's rulings, that lawyer abuses her privilege to practice law. When a lawyer abuses her privilege to practice law, that lawyer ceases to advance her cause or the ends of justice.

It is irrefutable that a lawyer owes her client zealous advocacy, but her zeal must be constrained within the bounds placed on her as an officer of the Court and under the Court's rules. Specifically, Rule 11 of the Federal Rules of Civil Procedure expressly sets forth the outer boundaries of acceptable attorney conduct. That rule prohibits a lawyer from asserting claims or legal positions that are not well-founded under existing law or through the modification, extension, or expansion of existing law. Rule 11 also prohibits an attorney from using the courts for a purpose unrelated to the resolution of a legitimate legal cause of action.

Regrettably, the conduct of counsel Orly Taitz has crossed these lines, and Ms. Taitz must be sanctioned for her misconduct. After a full review of the sanctionable conduct, counsel's conduct leading up to that conduct, and counsel's response to the Court's show cause order, the Court finds that a monetary penalty of \$20,000.00 shall be imposed upon counsel Orly Taitz as punishment for her misconduct, as a deterrent to prevent future misconduct, and to protect the integrity of the Court. Payment shall be made to the United States, through the Middle District of Georgia Clerk's Office, within thirty days of today's Order. If counsel fails to pay the sanction due, the U.S. Attorney will be authorized to commence collection proceedings. The Court does not take this action lightly, and in fact, cannot recall having previously imposed monetary sanctions upon an attorney sua sponte.

As the Orly Taitz case demonstrates, attorneys must take care to respect a court's authority at all times and conduct themselves in a civil manner. Most attorneys have no problem discharging this obligation to the judge, but it is to the jury that they focus their attention the most. In our legal system, the jury has a very special role to play in ensuring citizen participation in the administration of justice. As the trier of fact, the jury has the duty of determining the truth in any given situation: who said and did what, why, and when?

Do you know when someone is lying to you? Have you ever been lied to so well that you didn't find out about the lie until much later? Have your roommates or friends who were involved in a dispute ever asked you to decide who should win? In essence, being a juror relies on those same human skills. In every legal proceeding, each of the two adversarial sides, absolutely opposed to each other, claims that it is right and the other side is wrong. Our litigation system is a process by which each side gets to present its case to a group of stranger citizens, and then ask them to decide who is lying and who is telling the truth.

There are two types of juries. A grand jury is a group of citizens convened by the prosecution in serious criminal cases to determine whether there is probable cause to believe that a crime has occurred and whether it's more likely than not that the defendant in question committed the crime. The grand jury serves as a procedural step to prevent prosecutors from abusing their powers of arrest and indictment, a sort of "sanity check" on the awesome power of government to accuse citizens of crime. The grand jury requirement exists at the federal level and in some, but not all, states. A grand jury typically meets for an extended period of time and can hear several different cases in one day.

The grand jury does not determine guilt or innocence. A petit jury does that. This jury is impaneled for a specific trial. During the trial, members of the jury listen to the evidence presented and then deliberate as a group on what they believe the facts of the case are. They then apply the law, as instructed by the judge, to the facts. There are typically twelve members in a petit jury in criminal trials and from six to twelve members in civil trials, and generally speaking, they must arrive at a unanimous verdict.

The jury system is a jewel in our litigation system, for it involves ordinary citizens in adjudicating all sorts of disputes, from domestic family issues to complex business and insurance litigation to heart-wrenching criminal cases. There are problems with administering this system, however.

Both grand and petit juries are drawn from citizen voter and driver's license rolls. In high-profile cases, it may be difficult to find citizens who have not heard about the case or who can be impartial about the case, in spite of their promises to be open-minded. When Enron collapsed in 2001, for example, defense attorneys for former CEO Jeff Skilling argued strenuously that the trial should not be held in Houston, where almost every citizen was affected in some way by the energy giant's collapse or knew someone affected. The question of juror bias was so serious that the U.S. Supreme Court agreed to hear Skilling's appeal based partially on this argument. Although the Court eventually found that Skilling's jury was adequately impartial, Justice Sotomayor noted in a dissenting opinion that the "deep-seated animosity that pervaded the community at large" caused her great concern. [Skilling v. United States](#), 561 U.S. (2010).

Another problem arises from the burdens placed on jurors' personal lives through their service. While most states have laws that prevent an employer from firing a worker or taking any negative work action, such as demotion, against the worker for being on jury duty, there is no legal requirement that an employer continue to pay a worker on jury duty. The court system does not pay juries for their services either (although some court systems pay a small amount, typically less than twenty dollars per day, to cover food and transportation costs). Some citizens, such as those who are self-employed, are therefore at great risk of losing personal income by serving on juries. Imagine being on the O. J. Simpson criminal trial jury, for example—that trial lasted ten months. The effects of jury service on a juror's personal life can be staggering.

Another potential problem arises in the makeup of the jury itself. To provide a fair jury, courts attempt to draw from a cross-section of society to reflect the diversity of the surrounding community. Local court rules typically allow judges to excuse potential jurors for hardship or extreme inconvenience. If these rules are too generous, then the only citizens left may be those without full-time employment, such as students or retirees. Such a narrow cross-section of society would tend to skew the reliability and trust of the jury system, and judges across the country are becoming increasingly intolerant of attempts to evade jury service. The only professions that automatically exempt citizens from jury duty are active-duty soldiers, police officers, firefighters, and public officers.

In spite of these administrative problems, our jury system remains a cornerstone of litigation and is often openly admired. In South Korea, for example, attempts to create a more open and responsive democracy resulted in a novel and wholesale revision to the country's court system: the adoption of citizen juries.

Key Takeaways

The federal rules of civil procedure make it easy for parties in a lawsuit to identify and join other relevant parties and to make legal claims against each other. The goal of civil litigation is to find the truth. Litigants typically rely on lawyers to assist them in litigation. An attorney's highest duty is to the administration of justice. Lawyers are ethically bound to represent their clients with zealous advocacy. A grand jury acts as a body of citizens to prevent abuse of discretion by prosecutors. A petit jury sits in trials as the trier of fact to ascertain the truth through their observations of the presented evidence.

? Exercise 2.10.1

1. Can you think of a situation where an in-house attorney may advise you to retain your own counsel?
2. Most rules of legal professional conduct are drafted and enforced by the bar itself, but the Sarbanes-Oxley Act (passed in reaction to the Enron accounting scandal) imposed a legal duty on lawyers to report acts of misconduct in publicly traded corporations. Do you believe that the bar does an effective job of policing itself, or do you think external government agencies should be more involved?
3. Read the legal documents available for the Lynne Stewart case at "Learn More: The Lynne Stewart Case". Do you think that the U.S. government should be able to curb the attorney-client privilege when the client is a convicted terrorist? Or a suspected terrorist?
4. How aggressive should a lawyer be in representing his or her client "zealously"? Read the rest of Judge Land's order in "Learn More: A Question of Ethics". Do you think Orly Taitz's conduct warranted a twenty-thousand-dollar fine?
5. Do you think that juries can be trusted to always arrive at the truth? Why or why not?
6. Do you think the U.S. jury system should be adopted by other countries? What factors do you think should affect a country's decision to adopt a jury system?

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2.11: Standing and Personal Jurisdiction

Learning Objectives

- Explore the standing requirement.
- Understand how a court obtains personal jurisdiction over the parties.

Before a case can be litigated, parties have to demonstrate that they meet two pretrial requirements: standing and personal jurisdiction.

Standing is a constitutional requirement. Article III of the Constitution grants the judiciary the power to hear “cases” and “controversies.” This means actual cases and controversies, not merely hypothetical ones. Unlike some other jurisdictions, the standing requirement means that courts are unable to give advisory opinions. Let’s say, for example, Congress is considering whether or not to pass a law and would like to know whether the law is constitutional. Standing prevents this question from being litigated, because it’s not yet an actual case or controversy. Standing, therefore, is a doctrine that limits judicial overreach by circumscribing the types of cases that are litigated in our courts.

To demonstrate standing, a party has to prove first that it has an actual case to proceed. This is a procedural matter, and it requires the case to be brought at the right time. If a case is brought too early, it’s not yet ripe. If it’s brought too late, then the case is moot. For example, assume that a state is debating whether or not to pass a law that would require thirty hours of financial management classes before anyone is allowed to form his or her own company. If an entrepreneur who wishes to form her own company but doesn’t want to take the thirty hours of classes sues the state for an unconstitutional law, that lawsuit would be dismissed for being brought too early—it is not ripe since the law hasn’t been passed yet. Now let’s assume that the law has been passed, and the entrepreneur, who has abandoned her plans and is now working for someone else, sues the state anyway. That lawsuit would also be dismissed since it is now moot. Even if the entrepreneur won the case and the law was overturned, the remedy would be meaningless to her since she does not plan to take the class anyway.

In addition to being brought at the right time, the case has to be brought by the right person. To show standing, a plaintiff has to demonstrate that he has an actual stake in the litigation, or something of value that would be lost if he loses the case. Of course, if a plaintiff has lost money in a contract dispute or has been injured in a tort case, that is sufficient legal injury. Let’s say, for example, that your roommate is the victim of Internet fraud when she does not receive the goods that she paid for online. She would rather move on and forget the whole episode, but you are outraged and decide to sue the perpetrator in court. Even if the perpetrator admitted that it committed fraud, you would still lose the case because you’re not the right plaintiff here; your roommate is.

Cases that don’t involve monetary damages are sometimes more difficult to call. For example, what if a constitutional right is at stake? What standing does a citizen have to prove to file a lawsuit? Courts have generally held that merely being a taxpayer does not give standing to challenge government expenditures. So, for example, a citizen cannot sue the government to stop the war in Afghanistan just because he pays his taxes. If taxpayers don’t have standing to challenge government action, then who does?

In 2007, Massachusetts, along with eleven other states, sued the Environmental Protection Agency (EPA) to force the agency to regulate carbon dioxide as a pollutant. For years, the EPA had argued that carbon dioxide is not a pollutant and therefore could not be regulated. In response to the suit, the EPA argued that the states lacked standing since they couldn’t prove they had been harmed by excess carbon dioxide in the air. In a major decision, *Massachusetts v. EPA*, 549 U.S. 497 (2007), the Supreme Court ruled that the states had standing because they had suffered environmental degradation as a result of global warming brought about by excess carbon dioxide and that therefore the EPA has jurisdiction over carbon dioxide as a pollutant. This decision, along with the election of President Obama, led to a major policy reversal at the EPA, which is now aggressively pursuing the regulation of carbon pollution to combat global warming.

Another high-profile case on standing involves the Pledge of Allegiance. In 2000, a California attorney and physician sued the government because his daughter attended a school where the Pledge of Allegiance was recited every morning. The plaintiff, Michael Newdow, claimed that the pledge is unconstitutional under the First Amendment because it contains the words “under God.” In 2002, the Ninth Circuit Court of Appeals agreed with Newdow, ruling that the pledge is indeed unconstitutional. On appeal to the Supreme Court, the Court ducked the question of whether the pledge is unconstitutional. *Elk Grove Unified School*

District v. Newdow, 542 U.S. 1 (2004). Instead, the Court held that Newdow lacked standing to bring the lawsuit in the first place since he is a noncustodial parent. Only his wife, who had custody of the daughter, could bring the lawsuit.

It's important to note that standing doesn't have anything to do with the merits of the case. Being able to prove standing doesn't mean that you can win the case at hand. It only means that you've been able to clear a procedural bar toward proceeding with litigation.

Another procedural bar before a plaintiff can proceed is personal jurisdiction. Personal jurisdiction is different from subject matter jurisdiction, which is the power of a court to hear a case. Personal jurisdiction is the power of a court over specific litigants, and it requires litigants to have some form of minimum contacts with the state where the case is filed. Personal jurisdiction seeks to avoid inconvenient litigation, even if the case has actual merit. If you've never been to Nebraska, for example, and don't have any connections to Nebraska, then you might be very surprised to find that you're being sued in a Nebraska state court. In addition to that, you'd have to go to Nebraska to answer the lawsuit, hire local lawyers to assist you, and spend a lot of time and money in a state you have nothing to do with.

A court obtains personal jurisdiction over the plaintiff when the plaintiff files its lawsuit. Obtaining personal jurisdiction over the defendant can be a little trickier. Typically, there has to be some sort of connection between the defendant and the state where the court is located. For example, living in the state would create personal jurisdiction. Residency for purposes of personal jurisdiction is different from residency for other legal requirements, such as voting and driving. Even temporary residency, such as a college student studying out of state, creates residency for personal jurisdiction purposes. Moreover, merely being in the state temporarily creates personal jurisdiction. If you're driving through Nebraska, for example, and you're speeding on a local highway, Nebraska courts have jurisdiction to hear a speeding ticket issued against you. Owning property in a state also creates jurisdiction. For corporations, courts generally hold that personal jurisdiction is proper in the state of incorporation as well as in any state in which the corporation does business.

Personal jurisdiction, like standing, is a constitutional requirement. The due process clause of the Fourteenth Amendment requires government processes to be carried out fairly. In 1980, the Supreme Court heard an important case on personal jurisdiction involving a car crash in Oklahoma. *World-Wide Volkswagen v. Woodson*, 444 U.S. 286 (1980). The plaintiff purchased the car in New York and filed a lawsuit against the manufacturer (Volkswagen) and the distributor and retailer (car dealer). The distributor and the retailer moved to dismiss the case for lack of personal jurisdiction, arguing that they had no business in Oklahoma, had no employees or property there, and did not target citizens of Oklahoma to purchase vehicles from them in New York. The Supreme Court held in favor of the distributor and car dealer, finding that neither had "purposefully availed" themselves of the privileges that come from doing business in Oklahoma. The Court noted that for personal jurisdiction to attach, "substantial notions of fair play and justice" cannot be offended.

Today, most states have written these concepts into laws known as long-arm statutes. These statutes set forth the procedure by which out-of-state defendants can be required to appear before a local court. The statutes provide for how service of process can occur. Service of process is the process by which any defendant (both local and out-of-state) is notified that it is being sued. Service of process typically requires a copy of the summons (notice to appear before a court) to be personally delivered to the defendant or the defendant's agent. In the case of companies and other nonhuman entities, service of process is usually easy since they are required to have a registered agent as part of the process of forming an organization. Service can be more challenging with an individual, since some defendants know that litigation can be held up while service is attempted and therefore choose to avoid being served at all costs. While the best service is personal delivery of the summons, some states prescribe alternative methods such as leaving a copy with a family member while also mailing a copy.

The Internet era has raised some interesting personal jurisdiction issues. Does creating a website, for example, subject you to personal jurisdiction in all states where the website is accessible? Courts have ruled that the answer depends on what kind of website you have created. If it is a general informational website that describes a product, then there are insufficient minimum contacts to create personal jurisdiction. If, on the other hand, the website reaches out to specific customers and urges them to make a purchase, either through a shopping cart function or by calling the seller, then there are minimal contacts to justify jurisdiction.

Key Takeaways

Standing is a constitutional requirement that requires a plaintiff to prove that he or she is the right person to bring a lawsuit and that he or she is bringing the lawsuit at the right time. Taxpayers lack standing to sue the government just by being taxpayers. Legal injury does not have to be monetary-based; environmental harm, for example, may be sufficient to demonstrate standing. Standing has nothing to do with the merits of the underlying case. Courts must have personal jurisdiction over a defendant before litigation can proceed. Personal jurisdiction, a constitutional requirement, requires minimum contacts with the state such that substantial notions of fair play and justice are not offended. Once personal jurisdiction is established, service of process can occur, where a copy of the summons is delivered to the defendant. If the defendant lives out of state, a long-arm statute prescribes the method for service to occur. A website creates personal jurisdiction in any state where it reaches out to customers through a shopping cart function.

? Exercise 2.11.1

1. When President Obama nominated Hillary Clinton as Secretary of State in 2008, several constitutional scholars observed that it may be unconstitutional for her to assume the post due to an often-ignored section of the Constitution. What procedural bar stopped citizens from challenging the nomination?
2. Do you believe the Supreme Court acted properly by finding that states with environmental damage from global warming had standing to challenge the federal government?
3. In the Volkswagen car crash case, the manufacturer (Volkswagen, a German company) and the importer did not contest the personal jurisdiction of the Oklahoma state courts. Why do you think they submitted to jurisdiction so readily?
4. If a car dealer in a neighboring state runs advertisements in your state claiming that its deals are better than those of in-state dealers, does that out-of-state car dealer create personal jurisdiction in your state?
5. If you sell something on eBay, do you create personal jurisdiction in the buyer's state? Why or why not?
6. If you commit a tort on the Internet, do you create personal jurisdiction in the victim's state? For example, if you defamed someone who lives out of state on Facebook, have you created jurisdiction in that foreign state?

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2.12: Pretrial Procedures

Learning Objectives

- Explore pretrial procedures such as pleadings, discovery, and motions.
- Find out how class-action lawsuits are organized and prosecuted.
- Learn about issues and challenges facing parties during discovery.

After issues related to subject matter jurisdiction, standing, and personal jurisdiction are sorted out, and parties have hired counsel to represent them, then a dispute can proceed to the pretrial stage. In civil cases, litigation begins with the filing of a complaint by the plaintiff. The complaint is a simple document setting forth who the parties are, the facts of the case, and what specific laws the defendant has violated. (Each of these is a claim.) The complaint ends with a prayer for relief. The plaintiff may be seeking damages (money), specific performance in certain kinds of contract cases, or a temporary or permanent injunction. It is much easier to get a temporary injunction in the early stages of litigation because courts don't want to see the defendant take some action that may result in irreparable harm. For example, if a real estate development company wants to tear down an old shopping mall to build a new skyscraper, and one of the tenants in the old mall claims it still has a right to be there, the tenant may be able to obtain a temporary injunction stopping the demolition until the lease issues are sorted out. If the demolition is allowed to continue and the tenant later turns out to be the winner, it will be too late to grant the tenant any meaningful remedy.

Citizen advocacy groups with an anti-litigation public policy agenda often complain about frivolous lawsuits being filed in court. Most court systems have rules to prevent the filing of frivolous suits. In the federal system, the rules state that all claims must be signed by a lawyer certifying that to the “best of the person’s knowledge,” formed after “an inquiry reasonable under the circumstances,” the claim is not being presented for an unlawful purpose such as harassment and that the claims are either “warranted by existing law” or a non-frivolous argument for modifying existing law. In practice, this standard is quite easy to meet, and it’s hard to think of a factual scenario—other than the most absurd—that would rise to the level of being legally frivolous.

The complaint is filed with the clerk of the court where the suit is to be heard. Every court has a clerk’s office to handle administrative matters relating to litigation. Even though the court system is a public service, there is usually a fee associated with filing a complaint to cover some of the court’s costs.

The clerk will next issue a summons to the defendant, along with a copy of the complaint. The summons is sent to a process server to effect service on the defendant. When the defendant is served, it is very important for the defendant to respond to the complaint in a timely manner. Ignoring the complaint, even if the defendant believes the complaint is devoid of any merit, is a fatal error. If the defendant does not reply to the complaint, the plaintiff can ask the court to issue a default judgment against the defendant, including granting all the relief the plaintiff is asking for.

In certain types of cases, there may be a large number of plaintiffs injured by a defendant’s actions. This may happen in a product liability lawsuit where a product is purchased by many thousands of consumers, all of whom experience the same product failure. The batteries for Apple’s popular iPod, for example, had a high failure rate, leading to a large number of consumer claims. There may also be a large number of plaintiffs in financial services cases, where a financial institution or investment firm defrauds a large number of investors. In these cases, several lead plaintiffs may attempt to form a class in a class-action lawsuit against the defendants. Under federal civil procedure rules, class actions may be granted when there are so many plaintiffs that it is impractical for them to file separate lawsuits, there are questions of law or fact that are common to members of the class, and the lead plaintiffs will fairly and adequately protect the interests of the class.

The defendant must file an answer to the complaint within a specified period of time, typically thirty days. The answer is a paragraph-by-paragraph response to the complaint, admitting certain paragraphs and denying others. The answer may also contain an affirmative defense (self-defense in an assault charge, for example) that the defendant wishes to pursue. Taken together, the complaint and answer are known as the pleadings. The answer may admit, for example, noncontroversial claims by the plaintiff, such as the defendant’s name, address, and the nature of the defendant’s relationship with the plaintiff. Each time the defendant denies a plaintiff’s claim in the complaint, that sets up a controversy or argument that must be litigated. Reducing the number of claims to be resolved before an actual trial begins makes the trial shorter. For example, in many civil cases, the plaintiff will make

claims about liability and damages. A defendant may be willing to admit that it is liable but may argue about the plaintiff's claims for damages. This can sometimes lead to bifurcated trials, where the issues of liability and damages are litigated separately.

At any point in litigation, either party may file motions with the court. The motions are designed to short-circuit the litigation and lead to an early end to the lawsuit. Litigation is so time-consuming and expensive that either party would be gratified if the judge would simply cut the lawsuit short and declare a winner. One such motion is the motion to dismiss for failure to state a cause of action. In this motion, the defendant argues that even if it admits everything in the complaint is factually true, that doesn't lead to any legal liability. In other words, the defendant's conduct has not broken any laws. A similar motion is the motion for judgment on the pleadings. In this motion, one party asks the judge to decide the case based simply on the answer and complaint.

If a long period of time has passed since the incident in question and the filing of the lawsuit, a defendant may file a motion to dismiss based on the statute of limitations. Every civil and criminal action has a statute of limitations, which states that any claim or prosecution under the statute must be brought within a specified period of time, or it will be dismissed. Only a few crimes are exempt from the statute of limitations and can be prosecuted at any time: murder (in most states) and rape (in many states). The statute of limitations exists to encourage aggrieved parties to file their lawsuits quickly, while evidence is still fresh and relevant, and people have memories of what occurred. As time passes, evidence may become stale, witnesses may die or move away, and those who can be located can't remember what they saw or heard. In other words, the quicker a suit is filed, the more likely that the real truth will be discovered by litigation. For businesses, a statute of limitations also allows them to "close the books" on past liabilities, such as accounts payable or tax payments, knowing that too much time has passed for anyone to come collecting on those monies. It is possible, though, in many cases, to toll the statute of limitations. If an accountant commits fraud, for example, and a criminal complaint is filed, but the accountant flees overseas for many years, the statute of limitations does not run while the suspect is hiding.

In support of any motion, a party may submit an affidavit. Affidavits play an important role in pretrial procedure because they are an effective way for parties to tell their side of the story to the judge. They are limited, however, because even though they are given under oath, they may raise more questions and are not subject to examination by the other side.

After pleadings are filed, the litigation moves into the discovery phase. Discovery is a process in which each side finds out information about the other's case. Let's assume, for example, that you buy a new car and, within a few weeks, a tire falls off suddenly while you're driving. You would rightly conclude that there's something wrong with the car, so you sue the manufacturer. At this point, you have no idea what's wrong with the vehicle. Was the design flawed? Was there something wrong with the manufacturing of your specific vehicle? All you know is that new cars should not experience this sort of failure. After you file a lawsuit against the manufacturer, discovery allows you to find out more information about the vehicle so that you can effectively proceed with the lawsuit. You could find out what engineers did when they designed the vehicle and review records of similar accidents or factory records from the day your vehicle was produced.

Discovery is designed to prevent trial by surprise, where either side may suddenly produce a damning piece of evidence that allows it to win the trial. Since trials are based on the discovery of truth, they should be tried on the merits of the case rather than a party's deceit. In that spirit, the rules of discovery are written broadly to cover scope and obligation. In scope, any piece of evidence that may be relevant to the trial is discoverable. Even if evidence may be ruled later to be inadmissible for a legal reason, it is discoverable during discovery. In obligation, both parties are obligated to turn over material that supports their own case, without demand from the other side. If the material harms their own case, they have to turn it over if the other side asks for it.

There are four types of discovery. The simplest (and least expensive) is an interrogatory. These are written questions addressed to the other party. The questions tend to be simple and straightforward, dealing with uncontroversial matters such as a company's structure or the names and addresses of relevant witnesses.

A second type is a request for production. Using this form of deposition, a party can request the other party to produce written communications such as internal company reports, e-mails, product manuals, and engineering specifications. In some cases, physical evidence may also be produced. If you sued a vehicle manufacturer because your tire fell off while driving, for example, the manufacturer may ask you to produce your vehicle so that its engineers can inspect it. Failure to preserve and produce key evidence in litigation can lead to charges of spoliation, which may result in severe sanctions against the offending party.

A third form of discovery is a request for admission. Remember that a complaint contains a series of claims the plaintiff is making against the defendant, and the answer is mainly a series of denials of those claims. As each party finds more information about the

other's case in discovery, one party may ask the other to admit that one of the contested claims is true. Doing so narrows the issues for trial because it is one less thing that the jury has to decide. Asking a party to give up a contested claim can be done at any time during litigation. If not done as a formal method of discovery, it may be done as a stipulation instead. For example, in your trial against the vehicle manufacturer, you may ask the manufacturer to admit that your specific vehicle was manufactured on a specific date at a specific factory.

Finally, discovery can take the form of a deposition. A deposition is a sworn oral statement, in response to questions, given by a potential witness in a trial to the attorneys in the case. A deposition hearing is attended by the witness being deposed and lawyers from both sides, as well as a court reporter who keeps a written transcript of the entire deposition. In your product liability suit against your vehicle's manufacturer, for example, you might want to depose the safety engineer who designed the car's tire and braking systems. There is no judge present, so there is great latitude for parties to ask questions, even if those questions may result in testimony that is later inadmissible in court. Depositions serve to allow attorneys to prepare for trial by knowing everything a witness may say in court. They also serve to pin down a witness's testimony, since a witness who changes testimony between a deposition and trial can be easily impeached. Depositions are easily the most expensive form of discovery, sometimes requiring weeks or months of advance planning, travel, extra costs, and lost work time from witnesses being deposed. In some cases, they can degenerate without the presence of a judge, as "Video Clip: A Deposition Goes Awry" shows.

A Deposition Goes Awry

Although the policy behind liberal rules of discovery is to permit both sides to prepare adequately for trial, in effect, discovery is an expensive phase of litigation. With most lawyers charging by the hour, responding to discovery requests can quickly rack up daunting legal bills. Discovery can also drag out litigation to many months or years. Most large corporations find they must dedicate entire in-house staffs of attorneys, paralegals, and support staff to respond exclusively to discovery requests. The judge assigned to the case is supposed to supervise discovery and ensure that the parties respond in a timely manner, as well as make rulings on specific discovery requests and objections. Theoretically, a judge has the power to sanction parties for abusive discovery, up to and including ordering a default judgment against the offending party. There are, however, few meaningful sanctions that can be levied against parties that abuse discovery, and plaintiffs in particular have a vested interest in making discovery last longer than the price of a sought-after settlement. These issues are magnified in e-discovery, when mountains of electronic data have to be sifted through to find relevant discoverable material. Objections to turning over material that may be proprietary, privileged, or the result of the work product doctrine also become more time-consuming when parties are engaged in e-discovery.

During or after discovery, parties typically make a motion for summary judgment. This motion is designed to cut the trial short by asking the judge to decide based on the information discovered so far in the case. In essence, the party making the motion is saying, "Why have a trial?" since the evidence would lead any reasonable jury to the same and inevitable conclusion.

Key Takeaways

Litigation commences with the filing of a complaint by the plaintiff. If the plaintiff wishes to represent many others with the same claim against the same defendants, the plaintiff may try to certify the lawsuit as a class-action suit. Frivolous cases are prohibited in litigation, but it is relatively easy to argue that a case is not frivolous. The defendant files an answer to the complaint or risks a default judgment. Most civil and criminal cases must be brought within the prescribed statute of limitations. During the discovery phase of litigation, parties share and exchange information about each other's cases so that neither side is surprised during the trial. There are four methods for conducting discovery: interrogatories, requests for production, requests for admissions, and depositions.

? Exercise 2.12.1

1. During the Catholic priest sex scandal, many potential plaintiffs who were abused as children found that their lawsuits against the church and individual priests were barred by the statute of limitations because the abuse happened so many years ago. Do you believe that these lawsuits were rightfully barred? Why or why not? Should the statute be changed in sexual misconduct cases?
2. Do you think there are too many frivolous cases filed? If you answered yes, how would you revise the federal rules of civil procedure to raise the standard on what constitutes a frivolous case?

3. Look at a sample interrogatory at <http://www.justice.gov/atr/foia/frito-lay/8-16-96.htm>. This interrogatory was issued by the U.S. Department of Justice in an antitrust investigation against Frito-Lay for possible violations of the Sherman Antitrust Act. What do you notice about the questions? How long do you think it would take to compile a response to these questions? If you were the defendant, would you object to any of them? If so, on what grounds?

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2.13: The Trial and Appeal

Learning Objectives

- Learn about jury selection.
- Follow a trial from the opening statement to the closing arguments.
- Explore the public policy rationale for the trial system.

After discovery is finally completed, and assuming that neither side has been successful in short-circuiting litigation through motions, the case is finally scheduled for a trial. In civil litigation, this is a most unusual development, for well over 90 percent of cases filed are resolved or settled before a trial. If a case actually goes to trial, it means there are genuine issues of fact that the parties cannot resolve, and both sides are determined to see their side win. Remember that a trial is a fact-finding process, through which the trier of fact (the jury in most cases or the judge in a bench trial) attempts to determine what happened. The trier of fact applies the facts to applicable law as instructed by the judge and determines guilt or innocence in a criminal case, or liability or no liability in a civil case. The first step in this process is to seat a jury.

On any given day in a courthouse, several citizens may be called by a judge as potential jurors in a case. If a jury needs twelve members, it's not unusual for a judge to begin with a pool of more than fifty or sixty potential jurors to narrow down to a dozen. The process of selecting a petit jury is called *voir dire*.

Voir dire typically begins with the jurors filling out a written questionnaire. The questionnaire asks the jurors to identify their occupation, any work or occupational conflicts, and any potential conflicts of interest with the case. The process then continues with attorneys quizzing each potential juror in turn. During this questioning, attorneys ask each juror if he or she has any biases against upholding the law and whether he or she can keep an open mind during the trial.

If an attorney does not like a juror's response, that juror may be excused. There are two types of challenges to a potential juror: peremptory or for cause. A party can make a for-cause challenge if it can demonstrate to the judge that there is a good reason to excuse the juror, such as the juror's personal relationship with one of the parties, or the juror's stated unwillingness to be unbiased. Since these excuses are for a good reason, each side is allowed an unlimited number of for-cause challenges. A party can also make a peremptory challenge against a juror, without giving any reason for the challenge. Since these challenges are unsupported by rationale or reason, each side is given a limited number of peremptory challenges. A party may make a peremptory challenge based on a juror's perceived bias because of that juror's occupation or life background, but may not make a peremptory challenge because of the juror's race (*Batson v. Kentucky*, 476 U.S. 79 (1986)) or gender.

After a jury has been selected and sworn in, the trial begins. The plaintiff or prosecution begins by delivering an opening statement. The opening statement is a preview of the trial. In it, the attorneys explain the facts of the case to the jury and indicate what witnesses they will be calling and what the witnesses will say. Attorneys do not make any arguments during the opening statement; they simply lay out what jurors can expect from the trial ahead. In a trial against your vehicle's manufacturer, your attorney may begin by telling the jury to expect testimony from you about your car accident, from your doctor about the injuries you suffered, and perhaps from an expert witness who has examined your vehicle and believes it was manufactured defectively. Once the plaintiff has delivered an opening statement, the defendant will deliver the defense opening statement. In a criminal case, the defense has the right to reserve delivering the opening statement until after the prosecution has rested its case (concluded presenting all the witnesses).

After opening statements, the trial moves into the examination phase. Jurors are presented with witnesses, called by each side, to give evidence. The plaintiff begins by calling its witnesses. The attorney will guide the witness in delivering testimony by a series of short, open-ended questions during the direct examination. Leading questions (questions that call for a yes or no answer) are not permitted during direct examination. As the questioning proceeds, a court reporter maintains a record of all the words spoken in case there is an appeal. The opposing side may raise objections during the examination, which the judge will rule on. These rulings can also form the basis for a later appeal.

All the evidence in a trial must be introduced in this manner (questioning a live witness). If one side wants to introduce videotape into evidence, for example, it has to call the person who took the footage or was in charge of running the camera to testify about his or her personal knowledge of where the camera footage came from before the jury can watch the video. In a criminal case, if the

prosecution wants to introduce the murder weapon into evidence, it must first call the detective or police officer who found the weapon to testify about where he or she found it and where it has been since then.

Learn More: O.J. Simpson Tries on Gloves

O. J. Simpson's criminal murder trial was probably the most-watched courtroom proceeding in history. During the trial, the prosecution sought to introduce a pair of gloves into evidence. The prosecution claimed the gloves contained blood from the victims. In [this scene](#), the defendant, O. J. Simpson, is asked to try on the gloves so that the jury can see for themselves whether or not the gloves might belong to him. The fact that the gloves appear too small for his hands later becomes fertile ground for the defense attorneys to argue that reasonable doubt exists as to his guilt.

In a key moment in the trial, O.J. Simpson appears to struggle to put on one of the gloves recovered from the crime scene, claiming, "They don't fit," which would lead Johnnie Cochran to famously quip in closing arguments, "If it doesn't fit, you must acquit."

After direct examination, the other side has the right to conduct a cross-examination. During the cross-examination, the attorney will try to discredit the witness to convince the jury that the witness is not credible. The attorney may probe into any potential biases the witness may have or try to prove that the witness's recollection of events may not be as clear or certain as the witness believes. During cross-examination, attorneys frequently engage in asking leading questions, which is permitted.

Once the prosecution or plaintiff has called all its witnesses, and the witnesses have undergone direct and cross-examination, then the prosecution or plaintiff will rest its case. The defendant may make a motion for a directed verdict, arguing that no reasonable juror could possibly find in favor of the prosecution or plaintiff after hearing the evidence presented so far. This motion can be made anytime during the trial before the jury returns a verdict. The motion is typically denied, and the trial moves on to the defense phase. The defense will then present its witnesses, who are led through direct and cross-examination.

After the defense has rested its case, the attorneys once again address the jury in closing arguments. Here, the attorneys summarize the case for the jury. They address what witnesses were called and what the witnesses said. During closing arguments, the attorneys are permitted to be much more persuasive and argumentative than during the opening statement. They appeal to the jury's emotions and argue how the jury should interpret the evidence before them.

Johnnie Cochran Delivers Closing Arguments

After the closing arguments are made, the judge in the case charges the jury by giving the jury its instructions. The instructions acquaint the jury with the relevant law. The jury then retires to deliberate. During deliberations, the jury will decide first what facts it believes to be true. Then it will apply those facts to the law as outlined in the jury instructions. In a trial against your vehicle's manufacturer, for example, the judge may explain to the jury what is legally required for a product to be considered defective so that the jury can make a determination, based on the evidence presented, whether or not there is any liability.

Central to the jury's deliberations is the burden of proof applicable to the case. In criminal trials, the prosecution always carries the burden of proof. That burden is to prove the defendant committed all the elements required in the crime beyond a reasonable doubt. If any member of the jury has any reasonable doubts about the defendant's guilt or innocence, then the only appropriate verdict is not guilty. Many people confuse the burden with "without a doubt." Jurors may have doubts, but the only question for the jurors is whether they have any reasonable doubts. This standard is deliberately set high because of the severe sanctions and penalties that follow a criminal conviction. In a criminal trial, the defense only has to prove reasonable doubt exists and has no burden of proof at all. That is why in criminal trials, the defense may strategically decide not to call any witnesses and to rest its case strictly on creating doubt by cross-examining the prosecution's witnesses.

In civil cases, the burden of proof is preponderance of the evidence. This standard requires the scales of justice to tilt ever so slightly toward one party to declare that party the winner. If the jury believes one side is 51 percent correct and the other is 49 percent correct, that is enough to declare a winner. It is a much easier standard to win, because it only requires a party to prove that its side is more likely than not to tell the truth. In a civil liability suit against your vehicle's manufacturer, your burden is to convince the jury that more likely than not, your vehicle was somehow defective. Sometimes it's possible for a jury in a criminal trial to find the defendant not guilty, while a separate jury in a civil case applying a lower burden of proof finds the defendant liable for the same act. This is what happened to O. J. Simpson when he was tried for the murder of his wife.

During jury deliberations, the jurors are permitted to ask the judge for clarification about the law and to request to see the evidence again. If the jury is unable to come to a verdict, the jury is said to be deadlocked, and a mistrial results. Since trials are expensive and time-consuming, the judge will usually instruct the jury to try its best before giving up. If the jury does arrive at a decision, it is called a verdict.

Once the jury delivers its verdict, the losing side typically makes a motion for judgment notwithstanding the verdict. In this motion, the party is arguing that the jury arrived at the wrong verdict and that no reasonable jury could have arrived at that verdict. The judge typically will not grant this verdict. Even if the judge believes that the jury arrived at the wrong factual conclusion, the judge is not permitted to substitute his or her judgment for that of the jury. If, however, the jury clearly ignored the law in arriving at its verdict in a criminal case, the judge may overrule the jury. This phenomenon is known as jury nullification.

If the judge denies the motion for judgment notwithstanding the verdict, then the judge enters the jury's verdict as a judgment. After that, the losing party has the right to file an appeal. Remember that on appeal, the appellate court is only reviewing the record for legal error and cannot call new witnesses or substitute its judgment on the facts for the jury's. In the following excerpt, Supreme Court Justice Ruth Bader Ginsburg uses the trial record to make a point in her dissenting opinion in an important employment discrimination case involving gender discrimination. Although hers was a dissenting opinion and the plaintiff lost her case, Congress reacted to the decision by passing the Lily Ledbetter Fair Pay Act, the first law signed by President Obama after he assumed office.

Learn More: Justice Ginsburg Reviews an Employment Discrimination Case

[Ginsberg Dissent for Lilly M. Ledbetter v. Goodyear](http://www.law.cornell.edu) [www.law.cornell.edu]

From 1979 to 1998, Lilly Ledbetter worked as a supervisor at Goodyear's plant in Gadsden, Alabama. Over the course of her career, her pay slipped when compared to the pay of men of equal experience and seniority. She sued the company, alleging pay discrimination on the basis of her gender under Title VII of the 1964 Civil Rights Act. The law states that any lawsuit must be initiated within 180 days of the unlawful discriminatory act occurring. Ledbetter argued that each paycheck she received was an unlawful discriminatory act, so the fact that she filed her lawsuit within 180 days of her last paycheck means her lawsuit is within the time limit. Goodyear argued that the discriminatory act was the decision to pay her less, which took place many years ago, and that, therefore, her lawsuit is too late. In a 5–4 decision, the Supreme Court ruled in Goodyear's favor. In her dissent, Justice Ginsburg returns to the trial record to make her point that Ledbetter is the victim of unlawful discrimination. The following is from the dissenting opinion:

Specifically, Ledbetter's evidence demonstrated that her current pay was discriminatorily low due to a long series of decisions reflecting Goodyear's pervasive discrimination against women managers in general and Ledbetter in particular. Ledbetter's former supervisor, for example, admitted to the jury that Ledbetter's pay, during a particular one-year period, fell below Goodyear's minimum threshold for her position. Although Goodyear claimed the pay disparity was due to poor performance, the supervisor acknowledged that Ledbetter received a "Top Performance Award" in 1996. The jury also heard testimony that another supervisor—who evaluated Ledbetter in 1997 and whose evaluation led to her most recent raise denial—was openly biased against women. And two women who had previously worked as managers at the plant told the jury they had been subject to pervasive discrimination and were paid less than their male counterparts. One was paid less than the men she supervised. Ledbetter herself testified about the discriminatory animus conveyed to her by plant officials. Toward the end of her career, for instance, the plant manager told Ledbetter that the "plant did not need women, that [women] didn't help it, [and] caused problems." After weighing all the evidence, the jury found for Ledbetter, concluding that the pay disparity was due to intentional discrimination.

Once all appeals are exhausted, the winner in litigation can finally collect whatever damages it is entitled to. This process is called execution. If the loser is unable or unwilling to pay the judgment, the winner can petition the court to use its full legal resources, including asking the sheriff to seize the loser's assets for sale, to satisfy the judgment. The winner can also ask that the loser's wages be garnished until the judgment is satisfied. The loser in litigation cannot refile a civil lawsuit once it has been decided under the doctrine of res judicata. Just like criminal cases cannot be retried after acquittal under the double jeopardy clause of the Constitution, res judicata operates as a bar to relitigation.

Key Takeaways

The process of selecting a jury is called voir dire. Each side is permitted to question a potential juror and excuse that juror for any reason through a peremptory challenge or for a good reason through a for-cause challenge. A trial begins with opening statements where the parties lay out the essential facts of their case. Next, witnesses are called to provide testimonial evidence. The side calling the witness conducts a direct examination, while the opposing side conducts a cross-examination. After all witnesses are called, the parties make closing arguments to the jury, which then deliberates and applies the law as outlined in the jury instructions. The burden of proof in a criminal case is “beyond a reasonable doubt,” while the burden of proof in a civil case is “preponderance of evidence.” A jury’s verdict must be converted into a legal judgment by the trial judge. Once all appeals are settled, res judicata prevents the case from being tried again.

? Exercise 2.13.1

1. Why would a jury engage in jury nullification? If a jury cannot engage in nullification, what are its alternatives to express a similar view?
2. One of President Obama’s first acts as president was to sign into law a statute aimed at overturning the Ledbetter decision. How can Congress overturn the Supreme Court in this instance?
3. Although litigation is rightfully criticized as slow and expensive, res judicata means the parties have only one chance to “get it right.” Do you think relaxing the rules of res judicata would help with the expense and time involved in litigating cases?

Concluding Thoughts

The litigation system, publicly financed, is an important dispute-resolution mechanism that processes millions of cases in both state and federal courts every year. The system permits parties to air their grievances against each other in an open and transparent manner and is typically very effective at finding the truth. The jury system, in particular, is largely admired for its ability to involve ordinary citizens in an important form of civil service. For many businesses, however, litigation can be a vexing and distracting problem. The extraordinarily high costs associated with complex litigation, along with pressure from stakeholders to settle cases rather than litigate them fully, mean that most businesses would prefer to avoid litigation whenever possible. These problems have led many courts to experiment with various levels of reform, from mandatory pretrial settlement attempts to mandatory mediation to jury selection and management reforms. These reforms are aimed at maintaining the vitality and usefulness of the litigation system, which can be a trusted and valuable resource for all citizens and corporations.

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CHAPTER OVERVIEW

3: Civil and Criminal Law for Business

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3.1: Civil vs Criminal Law

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

Constitutional Authority to Regulate Business

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

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

White Collar Crime

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



Figure 3.1.1: White collar crimes are committed by business professionals within businesses with the intent of gaining or maintaining status. (Credit: Rawpixel/ pexels/ License: CC0)

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

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

Types of Business Crimes

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

Ponzi Schemes

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

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

Larceny and Embezzlement

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

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

Environmental Crimes

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

The following federal laws can carry criminal penalties:

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

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



Figure 3.1.2: White collar crimes are generally motivated by the desire to maintain or gain financial status. (Credit: TheDigitalWay/pixabay/ License: CC0)

Other Types of Business Crime

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

Violations of Antitrust Laws

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

Racketeering

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

Bribery

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

Money Laundering

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

Spamming

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

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

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

Conclusion

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

the individual, the organization he or she worked for, the community, and customers.

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3.2: Criminal Law and Business

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

Constitutional Rights

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

Frequent issues litigated in the courts are:

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



Figure 3.2.1: Both civil and criminal convictions are based on precedent. (Credit: PactoVisual/ pixabay/ License: CC0)

Components of Crime

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

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

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

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

Criminal Procedures

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

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

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

Criminal and Civil Law

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

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



Figure 3.2.2: Civil and criminal cases involve the court system. (Credit: Brett Sayles/ pexels/ License: CC0)

Initiation and Roles

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

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

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

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

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

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

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

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

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

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

Professional Negligence

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

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

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3.3: The Nature of Criminal Law

Learning Objectives

- Understand what crime is.
- Compare and contrast the differences between criminal law and civil law.
- Understand the constitutional protections afforded to those accused of committing a crime.
- Examine some common defenses to crime.
- Learn about the consequences of committing a crime.
- Explore the goals or purposes of punishment for committing a crime.

Imagine a bookkeeper who works for a physician's group. This bookkeeper's job is to collect invoices that are due and payable by the physicians' group and to process the payments for those invoices. The bookkeeper realizes that the physicians themselves are very busy, and they seem to trust the bookkeeper with the task of figuring out what needs to be paid. She decides to create a fake company, generate bogus invoices for "services rendered," and send the invoices to the physicians' group for payment. When she processes payment for those invoices, the fake company deposits the checks in its bank account—a bank account she secretly owns. This is a fraudulent disbursement, and it is just one of many ways in which crime occurs in the workplace.

When crime occurs in the workplace or in the context of business, the temptation might be to think that no one is "really" injured. After all, insurance policies can cover some losses. Sometimes people think that if the victims of embezzlement do not immediately notice the embezzlement, then they must not "need" the money anyhow, so no real crime has been committed. Of course, these excuses are just smokescreens. When an insurance company has to pay for a claim arising from a crime, the insurance company is injured, as are the victim and society at large. Similarly, the fact that wealthy people or businesses do not notice embezzlement immediately does not mean that they are not entitled to retain their property. Crime undermines confidence in social order and the expectations that we all have about living in a civil society. No crime is victimless.

A crime is a public injury. At the most basic level, criminal statutes reflect the rules that must be followed for a civil society to function. Crimes are an offense to civil society and its social order. In short, crimes are an offense to the public, and someone who commits a crime has committed an injury to the public.

Criminal law differs from civil law in several important ways. See Figure 3.3.1 "Comparison between Criminal Law and Civil Law" for a comparison. For starters, since crimes are public injuries, they are punishable by the government. It is the government's responsibility to bring charges against criminals. In fact, private citizens may not prosecute each other for crimes. When a crime has been committed—for instance, if someone is the victim of fraud—then the government collects the evidence and files charges against the defendant. When someone is charged with committing a crime, he or she is charged by the government in an indictment. The victim of the crime is a witness for the government but not for the prosecutor of the case. Note that our civil tort system allows a victim to bring a civil suit against someone for injuries inflicted on the victim by someone else. Indeed, criminal laws and torts often have parallel causes of action. Sometimes these claims carry the same or similar names. For instance, a victim of fraud may bring a civil action for fraud and may also be a witness for the state during the criminal trial for fraud.

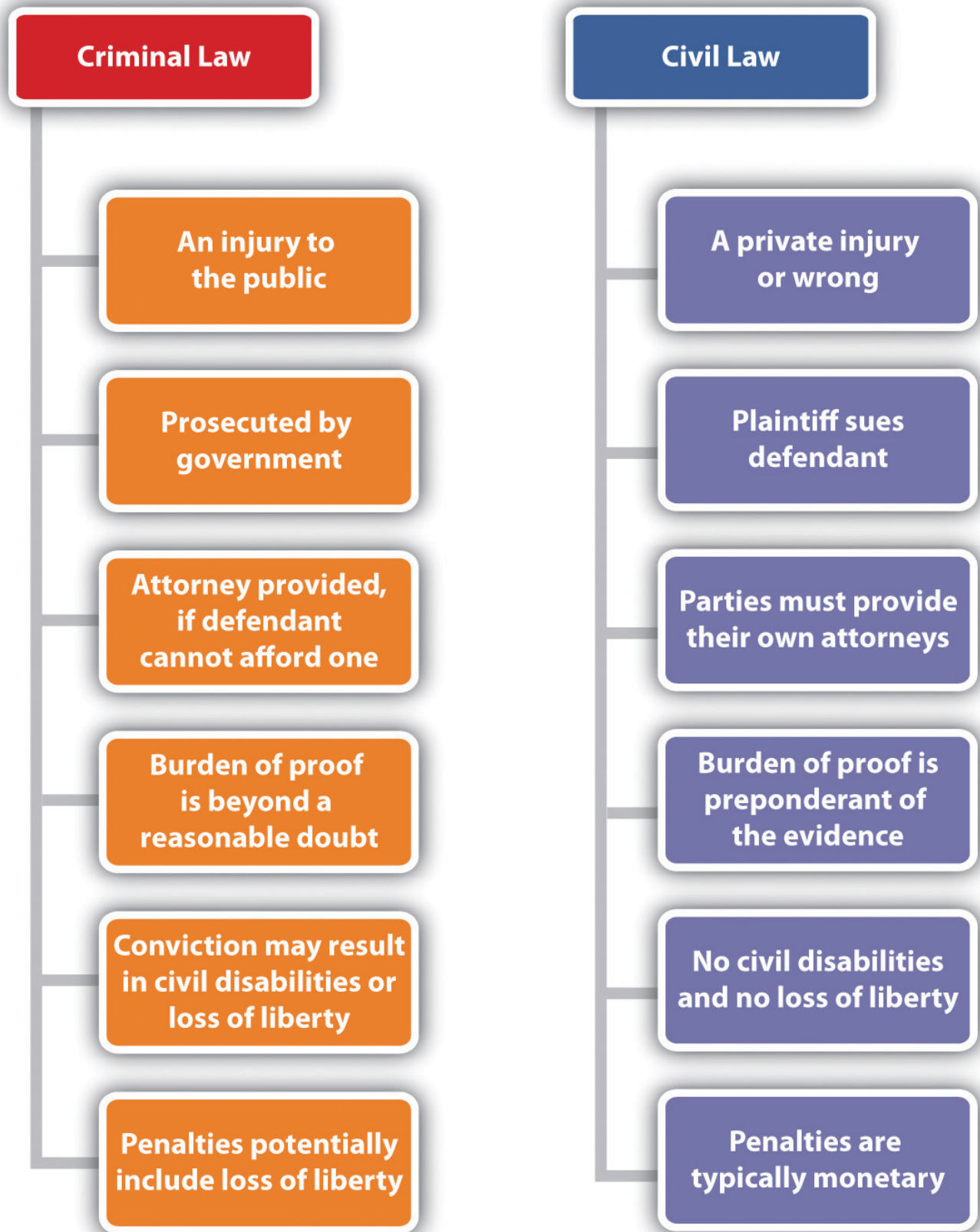


Figure 3.3.1: Comparison between Criminal Law and Civil Law

In a criminal case, the defendant is presumed to be innocent unless and until he or she is proven guilty. This presumption of innocence means that the state must prove the case against the defendant before the government can impose punishment. If the state cannot prove its case, then the person charged with the crime will be acquitted. This means that the defendant will be released, and he or she may not be tried for that crime again. The burden of proof in a criminal case is the prosecution's burden, and the prosecution must prove its case beyond a reasonable doubt. This means that the defendant does not have to prove anything, because the burden is on the government to prove its case. Additionally, the evidence must be so compelling that there is no reasonable doubt as to the defendant's guilt. To be convicted of a crime, someone must possess the required criminal state of mind, or *mens rea*. Likewise, the person must have committed a criminal act, known as *actus reus*.

Compare this to the standard of proof in a civil trial, which requires the plaintiff to prove the case only by a preponderance of the evidence. This means that the evidence to support the plaintiff's case is greater (or weightier) than the evidence that does not. It's useful to think of the criminal standard of proof—beyond a reasonable doubt—as something like 99 percent certainty, with 1 percent doubt. Compare this to the preponderance of the evidence, which we might think of as 51 percent in favor of the plaintiff's case, but up to 49 percent doubt. This means that it is much more difficult to successfully prosecute a criminal defendant than it is to bring a successful civil claim. Since a criminal action and a civil action may be brought against a defendant for the same incident, these differences in burdens of proof can result in verdicts that seem, at first glance, to contradict each other. Perhaps the most well-known cases in recent history in which this very outcome happened were the O. J. Simpson trials. Simpson was acquitted of murder in a criminal trial, but he was found liable for wrongful death in a subsequent civil action. Check out "Learn More: Not Guilty Might Not Mean Innocent" for a similar result in the business context.

Learn More: Not Guilty Might Not Mean Innocent

Richard Scrushy of HealthSouth was acquitted of several criminal charges relating to accounting fraud but was found civilly liable for billions. He was [subsequently found guilty in a later criminal case](#) for different crimes committed.

This extra burden reflects the fact that the defendant in a criminal case stands to lose much more than a defendant in a civil case. Even though it may seem like a very bad thing to lose one's assets in a civil case, the loss of liberty is considered to be a more serious loss. Therefore, more protections are afforded to the criminal defendant than are afforded to defendants in a civil proceeding. Because so much is at stake in a criminal case, our due process requirements are very high for anyone who is a defendant in criminal proceedings. Due process procedures are not specifically set out by the Constitution, and they vary depending on the type of penalty that can be levied against someone. For example, in a civil case, the due process requirements might simply be notice and an opportunity to be heard. If the government intends to revoke a professional license, then the defendant might receive notice by way of a letter, and the opportunity to be heard might exist by way of a written appeal. In a criminal case, however, the due process requirements are higher. This is because a criminal case carries the potential for the most serious penalties.

Constitutional Rights Relevant to Criminal Proceedings

A person accused of a crime has several rights, which are guaranteed by the U.S. Constitution. Many crimes are state law issues. However, many provisions of the U.S. Constitution's Bill of Rights, which contain the rights of concern to criminal defendants, have been incorporated as applicable to the states. This is known as the incorporation doctrine.

The Sixth Amendment guarantees that criminal defendants are entitled to an attorney during any phase of a criminal proceeding where there is a possibility of incarceration. This means that if a defendant cannot afford an attorney, then one is appointed for him or her at the state's expense.

The Fifth Amendment guarantees the right to avoid self-incrimination. This right means that the government cannot torture someone accused of committing a crime. Obviously, someone under the physical and psychological pain of torture will admit to anything, and this might be a strong incentive to allow torture if the government wanted someone to confess to a crime. However, the Fifth Amendment guarantees that people can choose to remain silent. No one is compelled to testify against themselves to make self-incriminating statements.

The Eighth Amendment prohibits cruel and unusual punishment. We do not employ many techniques that were once used to punish people who committed crimes. For instance, we do not draw and quarter people, which was a practice in England during the

Middle Ages. Recently, however, the question of the use of torture by the United States against aliens on foreign soil has been a hot topic. Many people believe that our Eighth Amendment protections should be extended to everyone held by U.S. authorities, whether they are on U.S. soil or not.

The Fourth Amendment provides a prohibition against illegal searches and seizures. This means that if evidence were obtained in violation of the Fourth Amendment, then it cannot be used against the defendant in a court of law. For Fourth Amendment requirements to be met, the government must first obtain a search warrant to search a particular area for particular items if there is a reasonable expectation of privacy in the area to be searched. The search warrant is issued only on probable cause. Probable cause arises when there is enough evidence, such as through corroborating evidence, to reasonably lead to the belief that someone has committed a crime.

If a valid search warrant is issued, then the government may search in the area specified by the warrant for the item that is the subject of the warrant. If a search occurs without a warrant, the search might still be legal, however. This is because there are several exceptions to the requirements for a search warrant. These include the plain view doctrine, exigent circumstances, consent, the automobile exception, lawful arrest, and stop and frisk. The plain view doctrine means that no warrant is required to conduct a search or to seize evidence if it appears in the plain view of a government agent, like a police officer. Exigent circumstances mean that no warrant is required in the event of an emergency. For instance, if someone is cruelly beating his dog, the state can remove the dog without a warrant to seize the dog. The exigent circumstances exception to the warrant requirement is used in hot pursuit cases. For example, if the police are in hot pursuit of a suspect who flees into a house, the police can enter the house to continue the pursuit without having to stop to first obtain a warrant to enter the house. Consent means that the person who has the authority to grant consent for a search or seizure has granted the consent. This does not necessarily have to be the owner of the location to be searched. For example, if your roommate consents to a search of your living room, which is a common area shared by you and your roommate, then that is valid consent, even if the police find something incriminating against you and you or your landlord did not consent to the search. The automobile exception means that an automobile may be searched if it has been lawfully stopped. When a police officer approaches a stopped car at night and shines a light into the interior of the car, the car has been searched. No warrant is required. If the police officer spots something that is incriminating, it may be seized without a warrant. Additionally, no warrant is required to search someone who is subject to lawful arrest. This exception exists to protect the police officer. For instance, if the police could not search someone who was just arrested, they would be in peril of injury from any weapon that the person in custody might have possession of. Similarly, if someone is stopped lawfully, that person may be frisked without a warrant. This is the stop-and-frisk exception to the warrant requirement.

In the business context, it is also important to note that administrative agencies in certain limited circumstances may conduct warrantless searches of closely regulated businesses, such as junkyards, where many stolen cars are disassembled for parts that can be sold.

Defenses

If the government violates a defendant's constitutional rights when collecting evidence, then the evidence gathered in violation of those rights may be suppressed at trial. In other words, it may not be used against the defendant in a trial. This is because evidence obtained through an illegal search is "fruit of the poisonous tree." The fruit of the poisonous tree doctrine is known as the exclusionary rule. You should know, however, that lying to the defendant or using forms of trickery and deceit are not constitutional violations.

Another common defense arises under the exclusionary rule regarding confessions. This is when the government, while holding someone in a custodial interrogation, questions that person without first reading the Miranda warnings. If someone is subjected to a custodial interrogation, he or she must first be read the Miranda warnings, which you have probably heard in the movies. Though the U.S. Supreme Court did not script the warnings specifically, the warnings are usually delivered in language close to this: "You have the right to remain silent. Anything that you say can and will be used against you in a court of law. You have the right to an attorney. If you cannot afford an attorney, one will be provided to you by the state. Do you understand your rights?"

The purpose of the Miranda warnings is to ensure that people understand that they have the right not to make self-incriminating statements and that they have the right to have counsel. If someone wants to invoke his or her rights, he or she has to do so unequivocally. "Don't I need a lawyer?" is not enough.

The Miranda warnings are not required unless someone is in custody and subject to interrogation. Someone in custody is not free to leave. So if a police officer casually strikes up a conversation with you while you are shopping in the grocery store and you happen to confess to a crime, that confession will be admissible as evidence against you even though you were not Mirandized. Why? Because you were not in custody and you were free to leave at any time. Likewise, if the police are not interrogating a person, then any statement made can also be used against that person, even if he or she is not Mirandized. Someone is being interrogated when the statements or actions by the police (or other government agents) are likely to give rise to a response.

Another defense provided by the U.S. Constitution is the prohibition against double jeopardy. The Fifth Amendment prohibits the government from prosecuting the same defendant for the same crime after he or she has already stood trial for it. This means that the government must do a very thorough job in collecting evidence prior to bringing a charge against a defendant, because unless the trial results in a hung jury, the prosecution will get only that one chance to prosecute the defendant.

Other defenses to crime are those involving lack of capacity, including insanity and infancy. Insanity is a lack of capacity defense, specifically applicable when the defendant lacks the capacity to understand that his actions were wrong. Infancy is a defense that may be used by persons who have not yet reached the age of majority, typically eighteen years of age. Those to which the infancy defense applies are not “off the hook” for their criminal actions, however. Juvenile offenders may be sentenced to juvenile detention centers for crimes they commit, with common goals including things like education and rehabilitation. In certain circumstances, juvenile offenders can be tried as adults, too.

Last, the state may not induce someone to commit a crime that he or she did not already have the propensity to commit. If the state does this, then the defendant will have the defense of entrapment.

Punishment

If convicted in a criminal case, the defendant will be punished by the government, rather than by the victim. Once a defendant is convicted of a crime, he or she is a criminal. Punishment for criminal offenses can include fines, restitution, forfeiture, probation, civil disabilities, and a loss of liberty. Loss of liberty means that the convicted criminal may be forced to do community service, may be subject to house arrest, may be incarcerated, or, in some states that have the death penalty, may even lose his or her life.

Length of incarceration varies depending on whether the conviction was for a misdemeanor or a felony. A misdemeanor is a less serious offense than a felony, as determined by the legislative body and reflected in the relevant statutes. Even an infraction, such as a parking ticket, is a criminal offense, typically carrying a penalty of a fine. An infraction is considered less serious than a misdemeanor.

When someone is convicted of violating a state criminal statute—a felony, misdemeanor, or infraction—the penalty will be set by the statute. For instance, the statute might state that the punishment will be “up to \$5,000” or “up to one year in jail.” Often, the possible punishments are given in a range, which allows the judge leeway to take other matters into consideration when sentencing the offender. For example, if someone is convicted of a misdemeanor that carries a penalty of up to one year in jail, but that person is a first-time offender with no prior criminal history, the judge might impose a sentence of some lesser time in jail, such as thirty days, or no jail time whatsoever.

Historically, all judges had the leeway to use their judgment when sentencing convicted criminals. However, disparities in sentences gave rise to concern about unequal treatment for similar offenses. In the 1980s, the U.S. Sentencing Commission established the Federal Sentencing Guidelines, which were understood to be mandatory guidelines that federal judges were expected to use when sentencing offenders. The mandatory nature of these guidelines led some to observe that extremely harsh penalties were mandated for relatively minor offenses, given certain circumstances. Today, however, the federal guidelines are only advisory, due to the U.S. Supreme Court’s decision in *United States v. Booker*, which held that a wide range of factors should be taken into consideration when sentencing offenders. *United States v. Booker*, 543 U.S. 220 (2005). This opinion restored to federal district court judges the power to exercise their judgment when sentencing federal offenders. Several states, however, passed their own versions of sentencing guidelines, and state trial court judges in those states must rely on those guidelines when sentencing state offenders. This has led to controversial “three strikes” laws, which can also carry extremely harsh penalties—such as incarceration for twenty-five years to life—for relatively minor offenses.

Often, the convicted criminal will be subject to various civil disabilities, depending on the state in which he or she lives. For instance, a felon, who is a criminal that has been convicted of a felony, may be prohibited from possessing firearms, running for

public office, sitting on a jury, holding a professional license, or voting. A felon may be subject to deportation if he or she is an illegal immigrant.

Besides loss of liberty and civil disabilities, other forms of punishment exist. Some of these are also appropriate in civil cases. Punishment for crimes also includes a fine, which is a monetary penalty for committing an offense. Fines can also be levied in civil cases. Restitution, which is repayment for damage done by the criminal act, is a common punishment for property damage crimes such as vandalism. Restitution can also be an appropriate remedy in civil law, particularly in contract disputes. Forfeiture, which means involuntarily losing ownership of property, is also a punishment, and it is commonly used in illegal drug trafficking cases to seize property used during the commission of a crime. Finally, probation is a common penalty for committing a crime. Probation is when the criminal is under the supervision of the court but is not confined. Typically, the terms of the probation require the criminal to periodically report to a state agent, such as a probation officer.

Purpose of Punishment

Conviction of a crime carries criminal penalties, such as incarceration. But what is the purpose of punishment? We do not have a vigilante system, where victims may bring their own form of justice to an offender. If we had such a system, we would have never-ending feuds, such as the infamous and long-standing nineteenth-century dispute between the Hatfields and McCoys from the borderlands of West Virginia and Kentucky.

Several goals could be the focus of a criminal justice system. These could include retribution, punishment, rehabilitation, the protection of society, or deterrence from future acts of crime. Our criminal justice system's penalties ostensibly do not exist for the purpose of retribution. Rather, rehabilitation, punishment, the protection of society, and deterrence from committing future crimes are the oft-cited goals. The Federal Bureau of Prisons captures some of these concepts in its mission statement. Federal Bureau of Prisons, "Mission and Vision of the Bureau of Prisons," www.bop.gov/about/mission.jsp (accessed September 27, 2010). Sadly, rehabilitation programs are not always available or, when they are, they are not always considered appropriate—or, when appropriate, they do not always work. Additionally, the goal of deterrence is not always achieved, as reflected in high recidivism rates in the United States.

Punishment of Business-Related Crime

Punishments committed by "white-collar criminals" are the same as those committed by any criminal. White-collar crime is a term used to describe nonviolent crimes committed by people in their professional capacity or by organizations. Individuals involved in white-collar crime are criminally liable for their own actions.

Additionally, since a corporation is a legal person, the corporation can be convicted of committing crimes, too. Accordingly, corporations can be punished. However, not all constitutional protections afforded to individuals are available to corporations. For instance, a corporation does not have the right against self-incrimination.

One difficulty that arises is the question of how to punish a corporation for engaging in criminal activity. After all, as they say, a corporation does not have a soul to rehabilitate or a body to incarcerate. Albert W. Alschuler, "Two Ways to Think about the Punishment of Corporations," *American Criminal Law Review, Public Law and Legal Theory Series*, No. 09-19, 2009, p. 13. This is a paraphrase of a remark first uttered by Lord Chancellor Thurlow between 1778 and 1792: "No soul to damn, no body to kick." This is very different from a human being, who will stand to lose his or her liberty or who might be subject to mandatory counseling.

We might argue that a criminal corporation should have its corporate charter revoked, which would be equivalent to a corporate death penalty. However, if that happened, a lot of innocent people who were not involved in the criminal activity would be harmed. For instance, employees would lose their jobs, and suppliers and customers would lose the goods or services of the corporate criminal. Entire communities could suffer the consequences of a few bad actors.

On the other hand, corporations must be punished to respect the goal of deterrence of future crimes. One way that corporations are deterred is by the imposition of hefty fines. It is not uncommon to base such penalties on some percentage of profits or all profits derived from the ill-gotten gains of criminal activity.

Corporations that are criminals also lose much in the way of reputation. Of course, reputational damage can be very difficult to repair.

Key Takeaways

Crime is a public injury. Criminal law differs from civil law in important ways, including who brings the claim, the burden of proof, due process, postconviction civil disabilities, and penalties. Those who are accused of committing a crime are afforded a high level of due process, including constitutional protections against illegal searches and seizures, self-incrimination, a guarantee of an attorney, and a prohibition against cruel and unusual punishment. Several common defenses to crimes exist. If convicted, criminals can face loss of liberty, with sentencing structures based on statutory language and, in the federal system, guided by the U.S. Federal Sentencing Guidelines. The goals of imposing penalties for violating criminal laws include protecting society, punishing the offender, rehabilitating the offender, and deterring future acts of crime. Corporations can also be convicted of crimes, though unique questions relating to appropriate means of punishment arise in that context.

? Exercise 3.3.1

1. Imagine a woman who suffers from dementia and lives in an assisted living facility. One day, she wanders into another resident's room and picks up an antique vase from the other resident's bureau. As she holds the vase, she forgets that it belongs to someone else and walks out of the room with it. Later, she places it on her own nightstand, where she admires it greatly. Has there been a crime here? Why or why not?
2. Consider the case of O. J. Simpson, in which a criminal jury acquitted him of murder, but a civil court found him liable for wrongful death. Both trials arose out of the same incident. Do you think that the burden of proof should be the same for a civil case as it is for a criminal case? Why?
3. What should be the goal of penalties or punishments for criminal offenses? Compare and contrast how our criminal justice system would differ if the goal of punishment was each of the following: retribution, rehabilitation, protection of society, or deterrence from future acts of crime.
4. Consider the difference between minimum security federal prison camps and medium or high-level security facilities. Should white-collar criminals receive the same punishment as those convicted of committing a violent crime? Why or why not?
5. How should a corporation be punished for committing a crime? Find an example of a corporation that was convicted of a crime. Do you believe that the punishment was appropriate? Discuss.
6. What kinds of crimes do college students commit? While the vast majority of college students wouldn't even think of committing a violent crime, many students do engage in crimes they believe to be victimless, such as downloading movies or buying and selling prescription drugs like Adderall or Ritalin. Are these crimes actually victimless?
7. The exclusionary rule was created by the Supreme Court as a means of punishing the police for violating a defendant's constitutional rights. Some legal commentators, including several members of the Supreme Court, believe the exclusionary rule should be abolished. Without it, how do you think society can ensure the police will not violate a citizen's constitutional rights?

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3.4: Intentional Torts and Negligence

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



Figure 3.4.1: Civil suits are decided in court by judges and juries. (Credit: Coffee/ pixabay/ License: CC0)

Torts

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

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

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

Table 3.4.1: Functions During a Tort Litigation

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

Harm

Two types of torts are intentional torts and negligence. **Intentional torts** occur as the result of a conscious and purposeful act. **Negligence** occurs when an individual does not exercise the duty of care. Torts are acts or omissions that result in injury or **harm** to an individual in such a way that it leads to a civil wrong that occurs as liability (WEX, n.d.). In tort law, harm can be defined as a loss or disadvantage suffered as a result of the actions or omissions of another (WEX, n.d.). This loss can be physical harm, such as

slipping and falling on a wet floor, or personal property harm, such as allowing water to ruin furniture. The damage is the result of what someone else did, or did not do, either intentionally or based on a lack of reasonable care.

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

Intentional Torts

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

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

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

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

Negligence

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

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

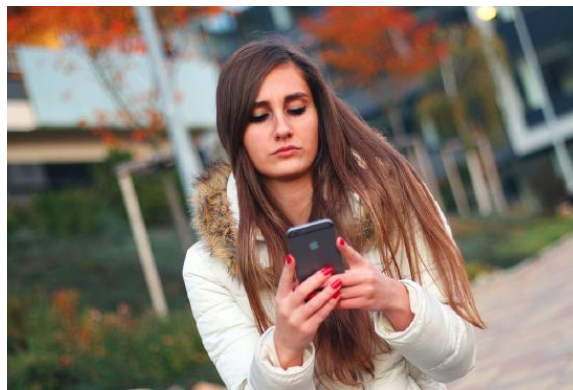


Figure 3.4.2: If an individual agrees to watch a child and the child is injured while that person pays attention to her cell phone, it would be considered negligence. (Credit: JESHOOTScorn/ pixabay/ License: CC0)

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

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

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

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

Foreseeability

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

Conclusion

Intentional torts and negligence arise based on intentional and unintentional acts committed by individuals. Damages are decided in civil courts by first determining fault and harm, and then by assigning a remedy. Sometimes, the damage can be excused if the circumstances indicate that the defendant acted with permission or in his or her own defense. The main standard used to make a decision is the reasonable standard of care: what would a reasonable person do?

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3.5: Product and Strict Liability

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

Strict Liability

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



Figure 3.5.1: If horses get out of a fenced-in area, the owner would be liable for any damage they cause while loose. (Credit: Slack/pexels/ License: CC0)

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

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

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

Trespass

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



Figure 3.5.2: Train tracks are a common area for trespassing. (Credit: Muscat_Coach/ pixabay/ License: CC0)

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

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

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

Product Liability

Individuals are not always the defendants involved in civil suits. Manufacturers, wholesalers, distributors, and retailers can also be named in torts that pertain to products and qualify as strict liability (CCBC Legal Studies, n.d.). Some products contain flaws that were not intentionally created; such flaws may not be discovered until an individual suffers harm as a result of using them.

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

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

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

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



Figure 3.5.3: If brakes do not work like they are supposed to, it could be the result of a manufacturing defect that would result in product liability. (Credit: Valtercirillo/ pixabay/ License: CC0)

The Unreasonably Dangerous Product Standard

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

- A flaw in the manufacturing process that occurred because the manufacturer failed to exercise proper care during manufacturing
- A defect in the design of the product, which makes it dangerous, and safer alternatives are available and economically feasible
- The product includes insufficient warnings or instructions for the proper use of the product and its potential dangers

Defenses

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

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

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



Figure 3.5.4: Using a chainsaw with bare feet could be dangerous and add to the risk of use without a guard. If the plaintiff suffered harm because his bare foot could not hold the wood down properly, he could be responsible for comparative negligence. (Credit: edman_eu/ pixabay/ License: CC0)

Plaintiffs might also be responsible for **comparative negligence**. With comparative negligence, the plaintiff's own actions in the use of the product contributed to the harm caused by the product, but the plaintiff might still receive damages (CCBC Legal Studies, n.d.). The amount of negligence on behalf of each part (plaintiff and defendant) is compared to determine the damages to

which the plaintiff is entitled (Baime, 2018). If a plaintiff is found to be 30% responsible, and the defendant 70% responsible, then the plaintiff would be entitled to 70% of the damages suffered.

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CHAPTER OVERVIEW

4: Contract Law

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4.1: Acceptance, Consideration, and Promissory Estoppel

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

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



Figure 4.1.1: Before a contract can become legal and enforceable, several elements must first be in place. (Credit: rawpixel/pixabay/ License: CC0)

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

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

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

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

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

Consideration and Promissory Estoppel

Contract law employs the principles of consideration and promissory estoppel.

Consideration

In most cases, consideration need not be pecuniary (monetary). Most contracts are enforceable only if each party gets consideration from the agreement. Consideration can be money, property, a promise, or some right. For instance, when a music company sells studio equipment, the promised equipment is the consideration for the buyer. The seller’s consideration is the money the buyer promises to pay for the equipment.

Promissory Estoppel

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

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

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

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

An example of how this principle would apply is:

✓ Example 4.1.1: promissory estoppel

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

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

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4.2: Capacity and Legality

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

The following are some examples of the application of these rules.

Minors Have No Capacity to Contract

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

✓ Example 4.2.1

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

Mental Incapacity

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

✓ Example 4.2.2

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

Voluntary Intoxication – Drugs and Alcohol

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

✓ Example 4.2.3

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

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

Legality

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

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

✓ Example 4.2.4

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

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

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

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

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4.3: Breach of Contract and Remedies

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

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

Material vs. Minor Breach

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

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

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

Remedies

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



Figure 4.3.1: When there is a breach of contract, the courts might get involved to help determine the remedy. (Credit: succo/pixabay/ License: CC0)

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

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

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

contract's substance.

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

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

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4.4: Nature of Sales Contracts

Features of Sales Contracts

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

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

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

Sources of Law for Sales Contracts

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

The Uniform Commercial Code

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

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

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

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

Table 4.4.1

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

Formation of Sales Contracts under the UCC

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

Table 4.4.2

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

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

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

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

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

Title

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

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



Figure 4.4.1: A sale is defined as a transaction that involves the passing of a title from the seller to the buyer for a price. (Credit: Negative Space/ pexels/ License: CC0)

Issues Associated with Title

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

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

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

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

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

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

A **simple delivery contract** occurs when the goods are transferred from the buyer to the seller at the time of the sale or later, e.g., if the goods are delivered. Title transfers when the contract is executed, insurable interest passes at the same time, and risk of loss

transfers when the buyer takes possession, unless the seller is not a merchant. In the latter case, under the rule of **tender of delivery**, risk remains with the buyer.

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

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

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

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

The International Sale of Goods

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

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4.5: Warranties and Sales Contracts

Warranties

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



Figure 4.5.1: The law provides remedies for breach of sales contracts. (Credit: rawpixel/ pexels/ License: CC0)

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

Express and Implied Warranties

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

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

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

Here are a few examples of express warranties:

“Wrinkle-free shirt”

“Lifetime guarantee”

“Made in the USA”

“This orange juice is not from concentrate.”

“24k gold”

There is no specific way that words must be formed to make an express warranty valid. Importantly, the sales contract does not need to explicitly state that a warranty is intended. It is enough that the seller asserts facts about the goods that then become part of the contract between the parties. However, the courts do apply a **reasonableness test of reliance** upon warranties. Puffery, or language used to bolster sales, is lawful, and the consumer is required to apply reason when evaluating such statements. For

example, buyers are expected to use reason when judging seller claims such as “this sandwich is the best in the world.” Obvious sales talk cannot ordinarily be treated as a legally binding warranty.

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

- Seller claims the warranty was true.
- Seller claims due care was exercised in the production or handling of the product.
- Seller claims there is no reason to believe that the warranty was false.

Implied Warranties

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

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

Breaches of Warranty

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

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

Specific Examples of Goods Under the Warranty of Merchantability

Table 4.5.1

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

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

Warranty of Title

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

Remedies to Buyers under the UCC

Table 4.5.2

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

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CHAPTER OVERVIEW

5: Business Organizations

5.1: Sole Proprietorships

5.2: Partnerships

5.3: Corporations

5.4: Limited Liability Organizations

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5.1: Sole Proprietorships

Learning Objectives

- Understand the importance of sole proprietorships in our economy.
- Explore the advantages presented by doing business as a sole proprietorship.
- Assess the disadvantages and dangers of doing business as a sole proprietorship.

Lily, a college sophomore, is home for the summer. Unable to find even part-time work in a tough economy, she begins to help her parents by cleaning up their overgrown garden. After a few days of this work, Lily discovers that she enjoys doing this and is good at it. The neighbors see the work Lily is doing, and they ask her to help their gardens too. Within a week, Lily has scheduled appointments and jobs throughout the neighborhood. Using the money she has earned, she places orders for additional landscaping equipment and materials with a local retailer. Within a month, she is so busy that she has to hire workers to do some of the more routine tasks, such as mulching and lawn mowing, for her. By the middle of summer, Lily has applied the knowledge she picked up in her business classes by developing a name for her business (Lily's Landscaping) and developing marketing materials such as a Facebook fan page, flyers to be posted at local stores, business cards, and a YouTube video showing her projects. By the end of the summer, Lily has earned a healthy profit for all her work and developed valuable know-how on how to run her business. She has to stop working when the weather gets cooler, and she returns to school, but promises herself to restart the business next summer.

Lily is a sole proprietor, the most common form of doing business in the United States. From a legal perspective, there is absolutely no difference between Lily and Lily's Landscaping—they are one and the same, and completely interchangeable with each other. If Lily's Landscaping makes a profit, that money belongs exclusively to Lily. If Lily's Landscaping needs to pay a bill to a supplier or creditor, and Lily's Landscaping doesn't have the money, then Lily has to pay the bill. When Lily's Landscaping enters into a contract to plant a new flower garden, it is actually Lily who is entering into the contract. If Lily's Landscaping wants to open a bank account to accept customer payments or to pay bills, then Lily will actually own the account. When Lily's Landscaping enters into a contract promising to pay a worker to mow lawns or lay mulch, it is actually Lily that is entering into that contract. Lily can even apply for a "doing business as" or d.b.a. filing in her state, so that her business can carry on under the fictitious name "Lily's Landscaping." Note, however, that legally Lily's Landscaping is still no different from Lily herself. Any fictitious name, therefore, cannot have any words in it that suggest a separate entity, such as "Corp." or "Inc."

Learn More: Doing Business As

The legal name for a sole proprietorship is the owner's name. Some business owners are happy to use their own names for their business, but for marketing and branding reasons, many business owners prefer to use a fictitious name. Using a fictitious name is permitted under state laws where the business operates, using a filing known as a d.b.a. filing. Explore [this website](#) to find out how to file a d.b.a. filing in your state.

There are many advantages to doing business as a sole proprietor, advantages that make this form of doing business extremely popular. First, it's easy to create a sole proprietorship. In effect, there is no creation cost or time, since there is nothing to create. The entrepreneur in charge of the business simply starts doing business, charging money, and providing goods or services. Depending on the business, some sole proprietors may need to obtain permits or licenses before they can begin operating. A pizza restaurant, for example, may need to obtain a food service license, while a bar or tavern may need to obtain a liquor license. A small grocery store may need a license to collect sales tax. Do not confuse these governmental permits with legal approval for a business organization; in a sole proprietorship, the license is granted to the individual owner.

Another key advantage of sole proprietorships is autonomy. Since the owner is the business, Lily can decide for herself what she wants to do with Lily's Landscaping. She could set her own hours, grow as quickly or slowly as she wants, expand into new lines of business, take a vacation, or wind down the business, all at her own whim and direction. That autonomy also comes with total

ownership of the business's finances. All the money that Lily's Landscaping takes in, even if it is in a separate bank account, belongs to Lily, and she can do with that money whatever she wants.

These advantages must be weighed against some very important disadvantages. First, since a sole proprietorship can have only one owner, it is impossible to bring in others to the business. Lily cannot bring in her college roommate to work on website design as a partner in the business, for example. In addition, since the business and the owner are identical, it is impossible to pass on the business to Lily. If Lily dies, the business dies with her. Of course, she can always sell or give away the business assets (equipment, inventory, as well as intangible assets such as customer lists and goodwill).

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. For example, if Lily decides to expand her business and asks her wealthy uncle to invest money in Lily's Landscaping, there is no way for her uncle to participate as a profit-sharing owner in the business. He can make a loan to her or enter into a profit-sharing contract with her, but there is no way for him to own any part of Lily's Landscaping. 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 a 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. Many sole proprietors resort to running their personal credit cards to the maximum limit or transferring balances between credit cards in the early stages of their business.

Learn More: Small Businesses Squeezed as Banks Limit Lending

During the Great Recession, many banks faced a liquidity crisis as loans they made performed poorly. Lending tightened, interest rates went up, credit lines went down, and standards became higher. The effect on many sole proprietors, including those featured in this [National Public Radio story](#), has been very challenging.

In certain industries, entrepreneurs may be able to find financing through venture capital. Venture capital firms combine funds from institutional investors and high-net-worth individuals (known as angel investors) to identify promising start-ups and to fund them in a private placement offering until the start-up has developed its technology to a commercially feasible stage. At that point, the venture capital firm seeks an exit strategy, typically through the sale of the business to the public in an initial public offering (IPO).

Tax planning can also be challenging for the sole proprietor. Since there is no legal distinction between the owner and the business, all the income generated by the business is treated as ordinary personal income to the owner. The United States has several income tax rates depending on the type of income being taxed, and ordinary personal income typically suffers the highest rate of taxation. Being able to plan effectively to take advantage of lower income tax rates is very difficult for the sole proprietor.

Finally, sole proprietors suffer from one hugely unattractive feature: unlimited liability. Since there is no difference between the owner and the business, the owner is personally liable for all the business's debts and obligations. For example, let's say that Lily's Landscaping runs into some financial trouble and is unable to generate planned revenue in a given month due to unexpectedly bad weather. Creditors of the business include landscaping supply stores, employees, and outside contractors such as the company that prints business cards and maintains the business website. Lily is personally liable to pay these bills, and if she doesn't, she can be sued for breach of contract. Some proprietors are very successful and can generate many hundreds of thousands of dollars in profit every year. Unlimited liability puts all the personal assets of the sole proprietor reachable by creditors. Personal homes, automobiles, boats, bank accounts, retirement accounts, and college funds—all are within reach of creditors. With unlimited liability, all it takes is one successful personal injury lawsuit, not covered by insurance or exceeding insurance limits, to wipe out years of hard work by an individual business owner.

For these reasons, while sole proprietors are still the most common way of doing business in the United States, they are in many ways the most unattractive. Thankfully, modern business law creates real and viable alternatives for sole proprietors, as we'll discuss shortly.

Key Takeaways

Sole proprietorships are the most common way of doing business in the United States. Legally, there is no difference or distinction between the owner and the business. The legal name of the business is the owner's name, but owners may carry on business operations under a fictitious name by filing a d.b.a. filing. Sole proprietors enjoy ease of start-up, autonomy, and flexibility in managing their business operations. On the downside, they have to pay ordinary income tax on their business profits, cannot bring in partners, may have a hard time raising working capital, and have unlimited liability for business debts.

? Exercise 5.1.1

1. Many household services professionals, such as carpenters, plumbers, and electricians, do business as sole proprietors. If they make a promise to their customers that their work (not the products themselves) will be free from defects for a certain period of time (i.e., a warranty), and then subsequently sell their business assets to another individual, is the buyer bound by the promises made by the seller? Why or why not?
2. D.b.a. statutes prohibit sole proprietors from using certain words such as "company," "Corp.," or "Inc." in their fictitious names. Why do you think this rule exists?
3. If a sole proprietor dies suddenly, what do you think happens to the business run by the sole proprietor?

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5.2: Partnerships

Learning Objectives

- Learn about how general and limited partnerships are formed.
- Explore the major differences between general and limited partnerships.
- Understand the major advantages and disadvantages of doing business as a general or limited partnership.

Let's assume that after her first summer running Lily's Landscaping, Lily decides that it's time to take her business to the next level. She has gathered a lot of expertise in running the operations in her business, from placing orders with suppliers to scheduling workers for client projects. She realizes, however, that she's not very good at marketing or accounting, and that if her business is to grow, she needs to bring someone on board who can create a strong brand and strategy for growth, as well as keep good records of her accounts so that she can plan for the future. Fortunately, her good friend Adam is a double major in accounting and marketing, and after a series of discussions, Adam and Lily decide to run Lily's Landscaping together.

Lily and Adam have formed a general partnership. The moment they agreed to run Lily's Landscaping together and to share in the profits and losses of the business, the partnership was formed. Although they formed their partnership verbally, most general partnerships are formed formally, with partners writing down their agreement in a special type of contract known as 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 the contract, the partners can modify this if they wish. As in a sole proprietorship, there is no state involvement in creating a general partnership because there is no separation from the business and the partners—they are legally the same.

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 (or the spouse or heir if the partner dies).

Learn More: A Law Firm Partner Is Fired

After a nearly twenty-year career, Evan Dawson was a partner at a major New York City law firm, White & Case. In 1988, the firm tried to persuade him to withdraw as a partner, but he refused. In July 1988, the other partners in the firm voted to dissolve the partnership and then immediately re-formed it, without Dawson as a partner. He had effectively been fired as a partner from a general partnership. Dawson filed a suit against White & Case for an "accounting," claiming that the "goodwill" of the law firm should be part of the valuation of the partnership. The common law in New York at the time was that professional partnerships, like law firms, had no goodwill. The reasoning behind the rule is that, as professionals, law firm partners develop and cultivate their own goodwill with clients, and if a partner leaves the firm, then the goodwill leaves with that partner. The New York Court of Appeals, in [its opinion](#) on this case, held that unless the partnership agreement states otherwise, goodwill is indeed an asset of the partnership and has to be distributed when the partnership is dissolved.

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

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.

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

In most states, they can form a limited partnership. A limited partnership has both general partners and limited partners. In this case, Lily and Adam will remain as general partners in the business, but the uncle can become a limited partner and enjoy limited liability. As a limited partner, the most he can lose is the amount of his investment in the business, nothing more. Limited partnerships have to be formed in compliance with state law, and limited partners are generally prohibited from participating in the day-to-day management of the business.

Key Takeaways

A general partnership is formed when two or more persons agree to share profits and losses in a joint business venture. A general partnership is not a separate legal entity, and partners are jointly and severally liable for the partnership's debts, including acts of malpractice by other partners. Income from a general partnership flows through to the partners, who pay tax at the ordinary personal income tax rate. In most states general partners can also bring in limited partners, creating a limited partnership. Limited partnerships must be formed in compliance with state statutes. Limited partners enjoy limited liability but generally cannot participate in the day-to-day management of the business.

? Exercise 5.2.1

1. John approaches his friend Kevin and offers Kevin 50 percent of the profits from his new online venture if Kevin designs the website for the venture. Kevin says nothing, and later that night begins work on the website, which he then sends to John for his approval. Have John and Kevin formed a general partnership? Why or why not?
2. Do you think it's ethical for a general partnership to fire a partner by dissolving the partnership and then re-forming without the dismissed partner? Why or why not?
3. Do modern professional firms, such as law firms or accounting firms, face the same problems as White & Case did in "Learn More: A Law Firm Partner Is Fired"? Why or why not?

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5.3: Corporations

Learning Objectives

- Learn about the advantages and disadvantages of corporations.
- Study the roles and duties of shareholders, directors, and officers in corporations.
- Explore issues surrounding corporate governance.
- Understand how corporations are taxed.



Figure 5.3.1: Apple Co-founder Steve Jobs. Source: Photo courtesy of acaben, [Flickr \[www.flickr.com\]](https://www.flickr.com/photos/acaben/).

We have explored sole proprietorships and partnerships, two common and relatively painless ways for persons to conduct business operations. Both these forms of business come with significant disadvantages, however, especially in the area of liability. The idea that personal assets may be placed at risk by business debts and obligations is rightfully scary to most people. Businesses, therefore, need a form of business organization that provides limited liability to owners and is also flexible and easy to manage. That is where the modern corporation comes in.

Consider, for example, tech entrepreneur and Apple co-founder Steve Jobs (Figure 5.3.1 "Apple Co-founder Steve Jobs"). As a young man, he was a college dropout without much ability in computer engineering. If doing business as a sole proprietor was his only option, Apple would not exist today. However, Jobs met a talented computer engineer named Steve Wozniak, and the two decided to pool their talents to form Apple Computer in 1976. A year later, the company was incorporated and in 1980 went public in an initial public offering (IPO). Incorporation allowed Jobs much more flexibility in carrying out business operations than a mere sole proprietorship could. It allowed him to bring in other individuals with distinct skills and capabilities, raise money in the early stage of operations by promising shares in the new company, and eventually become very wealthy by selling stock or securities in the company.

Learn More: Great Things in Business

Sole proprietorships are limited not just in a legal sense but also in a business sense. As Steve Jobs points out in [this video](#), great things in business are never accomplished with just one person; they are accomplished with a team of people. While Jobs may have had the vision to found Apple Inc. and maintains overall strategic leadership for the company, the products the company releases today are very much the result of the corporation, not any single individual.

Unlike a sole proprietorship or general partnership, a corporation is a separate legal entity, separate and distinct from its owners. It can be created for a limited duration, or it can have perpetual existence. Since it is a separate legal entity, a corporation has continuity regardless of its owners. Entrepreneurs who are now dead founded many modern companies, and their companies are still thriving. Similarly, in a publicly-traded company, the identity of shareholders can change many times per hour, but the corporation as a separate entity is undisturbed by these changes and continues its business operations.

Since corporations have a separate legal existence and have many legal and constitutional rights, they must be formed in compliance with corporate law. Corporate law is state law, and corporations are incorporated by the states; there is no such thing as a "U.S. corporation." Most corporations incorporate where their principal place of business is located, but not all do. Many companies choose to incorporate in the tiny state of Delaware even though they have no business presence there, not even an office cubicle. Delaware chancery courts have developed a reputation for fairly and quickly applying a very well-developed body of

corporate law 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 came to their conclusions.

Learn More: How to Incorporate in Your State

Since corporations are created, or *chartered*, under state law, business founders must apply to their respective state agencies to start their companies. These agencies are typically located within the Secretary of State. Explore how to [fill out the forms](#) for your state to start a company. You may be surprised at how quickly, easily, and inexpensively you can form your own company! Don't forget that your company name must not be the same as another company's name. (Most states allow you to do a name search first to ensure that the name is available.)

To start a corporation, the corporate founders must file the articles of incorporation with the state agency charged with managing business entities. These articles of incorporation may vary from state to state, but typically include a common set of questions. First, the founders must state the name of the company and whether the company is for-profit or nonprofit. The name has to be unique and distinctive, and must typically include some form of the words "Incorporated," "Company," "Corporation," or "Limited." The founders must state their identity, how long they wish the company to exist, and the company's purpose. Under older common law, shareholders could sue a company that conducted business beyond the scope of its articles (these actions are called *ultra vires*), but most modern statutes permit the articles to simply state the corporation can carry out "any lawful actions," effectively rendering *ultra vires* lawsuits obsolete in the United States. The founders must also state how many shares the corporation will issue initially, and the par value of those shares. (Of course, the company can issue more shares in the future or buy them back from shareholders.)

Unlike sole proprietorships, corporations can be quite complicated to manage and typically 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, attorney fees, 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 out of state. Imagine filing as a foreign corporation in all fifty states, and you can see why maintaining corporations can become expensive and unwieldy.

Owners of companies are called shareholders. Corporations can have as few as one shareholder or as many as millions of shareholders, and those shareholders can hold as few as one share or as many as millions of shares. In a closely held corporation, the number of shareholders tends to be small, while in a publicly traded corporation, the body of shareholders tends to be large. In a publicly traded corporation, the value of a share is determined by the laws of supply and demand, with various markets or exchanges providing trading space for buyers and sellers of certain shares to be traded. It's important to note that shareholders own the shares or stock in the company but have no legal right to the company's assets whatsoever. As a separate legal entity, the company owns the property.

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

Shareholders can be human beings or other corporate entities, such as partnerships or corporations. If one corporation owns all the stock of another corporation, the owner is said to be a parent company, while the company being owned is a wholly owned subsidiary. A parent company that doesn't own all the stock of another company might call that other company an affiliate instead of a subsidiary. Many times, large corporations may form subsidiaries for specific purposes, so that the parent company can have limited liability or advantageous tax treatment. 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 tort 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.

Corporate law is very flexible in the United States and can lead to creative solutions to business problems. Take, for example, the case of General Motors Corporation. General Motors Corporation was a well-known American company that built a global automotive empire that reached virtually every corner of the world. In 2009, the General Motors Corporation faced an unprecedented threat from a collapsing auto market and a dramatic recession, and could no longer pay its suppliers and other creditors. The U.S. government agreed to inject funds into the operation but wanted the company to restructure its balance sheet at the same time so that those funds could one day be repaid to taxpayers. The solution? Form a new company, General Motors Company, the “new GM.” The old GM was brought into bankruptcy court, where a judge permitted the wholesale cancellations of many key contracts with suppliers, dealers, and employees that were costing GM a lot of money. Stock in the old GM became worthless. The old GM transferred all of GM’s best assets to the new GM, including the surviving brands of Cadillac, Chevrolet, Buick, and GMC; the plants and assets those brands rely on; and the shares in domestic and foreign subsidiaries that the new GM wanted to keep. Old GM (subsequently renamed as “Motors Liquidation Company”) kept all the liabilities that no one wanted, including obsolete assets such as shuttered plants, as well as unpaid claims from creditors. The U.S. federal government became the majority shareholder of General Motors Company and may one day recoup its investment after shares of General Motors Company are sold to the public. To the public, there is very little difference between the old and new GM. From a legal perspective, however, they are totally separate and distinct from each other.

One exception to the rule of limited liability arises in certain cases, mainly involving closely held corporations. Many sole proprietors incorporate their businesses to gain limited liability but fail to realize that when they do so, they are creating a separate legal entity that must be respected as such. If sole proprietors fail to respect the legal corporation with an arm’s-length transaction, then creditors can ask a court to pierce the corporate veil. If a court agrees, then limited liability disappears, and those creditors can reach the shareholder’s personal assets. Essentially, creditors are arguing that the corporate form is a sham to create limited liability and that the shareholder and the corporation are indistinguishable from each other, just like a sole proprietorship. For example, if a business owner incorporates the business and then opens a bank account in the business name, the funds in that account must be used for business purposes only. If the business owner routinely “dips into” the bank account to fund personal expenses, then an argument for piercing the corporate veil can be easily made.

Not all shareholders in a corporation are necessarily equal. U.S. 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. For example, founders of a corporation may reserve a special class of stock for themselves with preemptive rights. These rights give the shareholders the right of first refusal if the company decides to issue more stock in the future, so that the shareholders maintain the same percentage ownership of the company and thus prevent dilution of their stock.

A good example of different classes of shareholders is in Ford Motor Company stock. The global automaker has hundreds of thousands of shareholders, but issues two types of stock: Class A for members of the public and Class B for members of the Ford family. By proportion, Class B stock is far outnumbered by Class A stock, representing less than 10 percent of the total issued stock of the company. However, Class B stock is given 40 percent voting rights at any shareholder meeting, effectively allowing holders of Class B stock (the Ford family) to block any shareholder resolution that requires two-thirds approval to pass. In other words, by creating two classes of shareholders, the Ford family continues to have a strong and decisive voice on the future direction of the company even though it is a publicly traded company.

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 may also include the right to vote in shareholder meetings, typically held annually. It is common in large companies with thousands of shareholders for shareholders to not attend these meetings and instead cast their votes on shareholder resolutions through the use of a proxy.

Under most state laws, including Delaware’s business laws, shareholders are also given a unique right to sue a third party on behalf of the corporation. This is called a shareholder derivative lawsuit (so called because the shareholder is suing on behalf of the corporation, having “derived” that right by virtue of being a shareholder). In essence, a shareholder is alleging in a derivative lawsuit that the people who are ordinarily charged with acting in the corporation’s best interests (the officers and directors) are failing to do so, and therefore the shareholder must step in to protect the corporation. These lawsuits are very controversial because they are typically litigated by plaintiffs’ lawyers working on contingency fees and can be very expensive for the corporation to

litigate. Executives also disfavor them because oftentimes, shareholders sue the corporate officers or directors themselves for failing to act in the company's best interest.

One of the most important functions for shareholders is to elect the board of directors for a corporation. Shareholders always elect a director; there is no other way to become 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 new decisions, such as a new plant or factory or entry into a new foreign market; appointing and removing corporate officers; determining employee compensation, especially bonus and incentive plans; and issuing new shares and corporate bonds. Since the board doesn't meet that often, the board can delegate these tasks to committees, which then report to the board during board meetings.

Shareholders can elect anyone they want to a board of directors, up to the number of authorized board members as set forth in the corporate documents. Most large corporations have board members drawn from both inside and outside the company. Outside board members can be drawn from other private companies (but not competitors), former government officials, or academe. It's not unusual for the chief executive officer (CEO) of the company to also serve as chair of the board of directors, although the recent trend has been toward appointing different persons to these functions. Many shareholders now actively vie for at least one board seat to represent the interests of shareholders, and some corporations with large labor forces reserve a board seat for a union representative.

Board members are given wide latitude to make business decisions that they believe are in the best interest of the company. Under the business judgment rule, board members are generally immune from second-guessing for their decisions as long as they act in good faith and in the corporation's best interests. Board members owe a fiduciary duty to the corporation and its shareholders, and therefore are presumed to be using their best business judgment when making decisions for the company.

Shareholders in derivative litigation can overcome the business judgment rule, however. Another fallout from recent corporate scandals has been increased attention to board members and holding them accountable for actually managing the corporation. For example, when WorldCom fell into bankruptcy as a result of profligate spending by its chief executive, board members were accused of negligently allowing the CEO to plunder corporate funds. Corporations pay for insurance for board members (known as D&O insurance, for directors and officers), but in some cases, D&O insurance doesn't apply, leaving board members to pay directly out of their own pockets when they are sued. In 2005, ten former outside directors for WorldCom agreed to pay \$18 million out of their own pockets to settle shareholder lawsuits.

One critical function for boards of directors is to appoint corporate officers. These officers are also known as "C-level" executives and typically hold titles such as chief executive officer, chief operating officer, chief of staff, chief marketing officer, and so on. Officers are involved in everyday decision-making for the company and implementing the board's strategy into action. As officers of the company, they have legal authority to sign contracts on behalf of the corporation, binding the corporation to legal obligations. Officers are employees of the company and work full-time for the company, but can be removed by the board, typically without cause.

In addition to being somewhat cumbersome to manage, corporations possess one very unattractive feature for business owners: double taxation. Since corporations are separate legal entities, taxing authorities consider them as taxable persons, just like ordinary human beings. A corporation doesn't have a Social Security number, but it does have an Employer Identification Number (EIN), which serves the same purpose of identifying the company to tax authorities. As a separate legal entity, corporations must pay federal, state, and local tax on net income (although the effective tax rate for most U.S. corporations is much lower than the top 35 percent income tax rate). That same pile of profit is then subject to tax again when it is returned to shareholders as a dividend, in the form of a dividend tax.

One way for closely held corporations (such as small family-run businesses) to avoid the double taxation feature is to elect to be treated as 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, it is taxed only once, at the shareholder level when a dividend is declared, and not at the corporate level. Shareholders then pay personal income tax when they receive their share of the corporate profits. 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 by not paying any corporate taxes. There are some important restrictions on S corporations, however. They cannot have more than one

hundred shareholders, all of whom must be U.S. citizens or resident aliens; can have only one class of stock; and cannot be members of an affiliated group of companies. These restrictions ensure that “S” tax treatment is reserved only for small businesses.

Key Takeaways

A corporation is a separate legal entity. Owners of corporations are known as shareholders and can range from a few in closely held corporations to millions in publicly held corporations. Shareholders of corporations have limited liability, but most are subject to double taxation of corporate profits. Certain small businesses can avoid double taxation by electing to be treated as S corporations under the tax laws. State law charters corporations. Shareholders elect a board of directors, who in turn appoint corporate officers to manage the company.

? Exercise 5.3.1

1. Henry Ford (Ford Motor Company), Ray Croc (McDonald’s), and Levi Strauss (Levi’s) were all entrepreneurs who decided to incorporate their businesses and, in doing so, created long-lasting legacies that outlive them. Why do you think these entrepreneurs were motivated to incorporate when incorporation meant giving up control of their companies?
2. Some corporations are created for just a limited time. Can you think of any strategic reasons why founders would create a corporation for just a limited time?
3. Recently, some companies have come under fire for moving their corporate headquarters out of the country to tax havens such as Bermuda or Barbados. Which duty do you believe is higher, the duty of corporations to pay tax to the government or the duty of corporations to pay dividends to shareholders? Why?
4. Some critics believe that the corporate tax code is a form of welfare, since many U.S. corporations make billions of dollars and don’t pay any tax. Do you believe this criticism is fair? Why or why not?
5. It is very easy to start a corporation in the United States. Take a look at how easy it is to start a corporation in China or India. Do you believe there is a link between ease of starting businesses and overall economic efficiency?
6. Do you agree with filmmaker Achbar that a corporation might be psychopathic? What do you think the ethical obligations of corporations are? Discuss.

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5.4: Limited Liability Organizations

Learning Objectives

- Learn about the development of limited liability entities.
- Explore how limited liability entities are created.
- Understand why limited liability entities are now heavily favored.

By now, you should understand how easy yet dangerous it is to do business as a sole proprietor, and why many business organizations are drawn to the corporation as a form for doing business. As flexible as the corporation is, however, it is probably best suited for larger businesses. Annual meeting requirements, the need for directors and officers, and the unattractive taxation features make corporations unwieldy and expensive for smaller businesses. A form of business organization that provides the ease and simplicity of sole proprietorships, but the limited liability of corporations, would be much better suited for a wide range of business operations.

A limited liability company (LLC) is a good solution to this problem. LLCs are a “hybrid” form of business organization that 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 real persons, or they can be other LLCs, corporations, or partnerships. Compared to limited partnerships, LLC members can participate in the day-to-day management of the business. Compared to S corporations, LLC members can be other corporations or partnerships, are not restricted in number, and may be residents of other countries.

Taxation of LLCs is very flexible. Essentially, every tax year, the LLC can choose how it wishes to be taxed. It may want to be taxed as a corporation, for example, and pay corporate income tax on net income. Or it may choose instead to have income “flow through” the corporate form to the 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.

LLCs are formed by filing the articles of organization with the state agency charged with chartering business entities, typically the Secretary of State. Starting an LLC is often easier than starting a corporation. In fact, you might be startled at how easy it is to start an LLC; typical LLC statutes require only the name of the LLC and the contact information for the LLC’s legal agent (in case someone decides to file a lawsuit against the LLC). In most states, forming an LLC can be done by any competent business professional without any legal assistance, for minimal time and cost. Unlike corporations, there is no requirement for an LLC to issue stock certificates, maintain annual filings, elect a board of directors, hold shareholder meetings, appoint officers, or engage in any regular maintenance of the entity. Most states require LLCs to have the letters “LLC” or the words “Limited Liability Company” in the official business name. Of course, LLCs can also file d.b.a. filings to assume another name.

Although the articles of organization are all that is necessary to start an LLC, it is advisable for the LLC members to enter into a written LLC operating agreement. The operating agreement typically sets forth how the business will be managed and operated. It may also contain a buy/sell agreement, just like a partnership agreement. The operating agreement allows members to run their LLCs any way they wish to, but it can also be a trap for the unwary. LLC law is relatively new compared to corporation law, so the absence of an operating agreement can make it very difficult to resolve disputes among members.

LLCs are not without disadvantages. Since they are a separate legal entity from their members, members must take care to interact with LLCs at arm’s length, because the risk of piercing the veil exists with LLCs as much as it does with corporations. Fundraising for an LLC can be as difficult as it is for a sole proprietorship, especially in the early stages of an LLC’s business operations. Most lenders require LLC members to personally guarantee any loans the LLC may take out. Finally, LLCs are not the right form for taking a company public and selling stock. Fortunately, it is not difficult to convert an LLC into a corporation, so many start-up businesses begin as LLCs and eventually convert into corporations prior to their initial public offering (IPO).

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.

Key Takeaways

The limited liability company (LLC) represents a new trend toward business organization. It allows owners, called members, to have limited liability just like corporations. Unlike corporations, however, LLCs can avoid double taxation by choosing to be taxed like a partnership or sole proprietorship. Unless a business wishes to become publicly traded on a stock exchange, the LLC is probably the most flexible, most affordable, and most compatible form for doing business today. The limited liability partnership (LLP) is similar to the LLC, except it is designed for professionals such as accountants or lawyers who do business as partners.

? Exercise 5.4.1

1. Most small businesses in the United States are still run as sole proprietorships. Why do you think these businesses have not converted to the LLC form?
2. Take a look at some of the brands and businesses you are most familiar with. How many of them do business as an LLC?

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CHAPTER OVERVIEW

6: Employment Law

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6.1: Employment, Worker Protection, and Immigration

Compared to other countries in the West, stringent and extensive employee protections came fairly late to the United States. Up until 1959, for example, employers had the right to fire a worker without giving any reason. This concept, which was known as **at-will employment**, was applicable in all states. The concept of at-will employment does, however, continue today, and all employees are considered to be at-will unless they are employed under a collective bargaining agreement or under a contract for a set duration. Employers can still fire employees for any reason, but they cannot be fired for illegal reasons, as set out in the U.S. or state constitutions, federal law, state statutes, or public policy. In this section, some of the main employee rights and company responsibilities will be introduced.



Figure 6.1.1: Employees have various rights in the workplace, and companies have various responsibilities toward them. (Credit: Raw Pixel/ pexels/ License: CC0)

Health and Safety

Workers have the right to be safe at work, and companies have responsibilities to employees in the event that they are harmed while undertaking work on behalf of the employer. The **Occupational Safety and Health Act**, passed in 1970, is the main legislative action that governs health and safety in the workplace. The Act established the **Occupational Safety and Health Administration (OSHA)**, which is a federal agency whose role is to “assure safe and healthy working conditions for working men and women by setting and enforcing standards and by providing training, outreach, education, and assistance.” Private employers and federal government agencies are all covered under OSHA protection, although the self-employed and workers at state and local governments in most states are not covered. OSHA has adopted thousands of regulations to enforce the Occupational Safety and Health Act. It imposes a number of record-keeping and reporting requirements on private employers. In addition, employers are required to inform employees of their health and safety rights by posting appropriate notices in the workplace.

Table 6.1.1

Type of OSHA Standard	Description	Example
Specific Duty Standards	Standards that apply to specific types of work, procedures, work conditions, and equipment	Safe handling of compressed gas cylinders
General Duty Standards	Standards that apply to all employers and that impose a duty to protect workers from known hazards	Standards pertaining to indoor air quality and workplace violence

Workers’ Compensation Acts help employees claim compensation for injuries that occur on the job. States require employers to either purchase workers’ compensation insurance or have the ability to self-insure against compensation claims. Workers’ compensation insurance covers a range of different injuries, including physical injuries, mental illnesses that can be shown to be employment-related, and stress.

Under the terms of the Acts, a **Workers’ Compensation Agency** is established at the state level to provide judicial and administrative services to help in the resolution of claims for compensation. In the event of a claim, a three-step process is put into place:

1. The worker files a claim with the agency.

2. The agency establishes the legitimacy of the claim.
3. If the injury is determined to be legitimate, compensation benefits are paid accordingly.

It is important to note that workers' compensation is understood to be an **exclusive remedy**. This term means that workers cannot sue the employer in court for further damages beyond that which is paid out under the compensation claim. An exception is made when the employer intentionally injures the worker, however. Furthermore, workers have the right to sue any third party involved in the cause of the injury to recover additional damages.

Case Insight

In the case of *Chad A. Kelley v. Marsha P. Ryan, Administrator, Ohio Bureau of Workers' Compensation, and Coca-Cola Enterprises*, Chad A. Kelley attended a team-building event held by his employer, Coca-Cola, to celebrate the launch of a new product. All employees attending the event were required to canoe down a river, which Kelley, with colleagues, achieved without incident. Employees waiting on the riverbank began to splash one another, and according to witnesses, Kelley said that it would take more than some splashing to get him wet. Consequently, several colleagues tried to throw Kelley into the water, which led him to sustain neck injuries. The Ohio Bureau of Workers' Compensation denied Kelley's claim for benefits, however, arguing that Kelley had instigated "horseplay" that removed the incident from the scope and course of employment. In 2009, an appellate court ruled that this conclusion was incorrect and that the employer was, in fact, responsible. Kelley was entitled to the compensation.

Fair Labor Standards Act

The Fair Labor Standards Act (FLSA) sets out provisions that delineate fair labor and unfair labor. There are three main categories covered in the Act:

1. Child labor
2. Minimum wage provisions
3. Overtime pay requirements

The FLSA prohibits oppressive **child labor** as well as the shipping of goods produced by firms that make use of oppressive labor. The FLSA sets the minimum age for non-agricultural work as 14. However, there are some exceptions. People under the age of 14 who are classed as minors may deliver newspapers, perform babysitting or chores around the home, and can work in businesses owned by their families, as long as the work is not deemed to be hazardous. In addition, minors may perform in television, radio, movie, or theatrical productions. Once an employee becomes 18, child labor regulations no longer apply.

Under the terms of the FLSA, employees in covered industries, with the exception of apprentices and students, must be paid the federal minimum wage. Congress is responsible for reviewing the level of the minimum wage on a periodic basis and raising it to compensate for increases in the cost of living caused by inflation. In 2009, Congress raised the federal minimum wage to \$7.25 an hour. This increase was the first in almost a decade (although in 2014, President Obama signed an executive order that increased the minimum wage to \$10.10 for those employed on new federal contracts).

FLSA also mandates that employees who work more than 40 hours in a week should receive overtime pay that is equal to at least one and one-half times their regular wage for every additional hour worked. Four categories of employees are excluded from this provision, however: executives, administrative employees, professional employees, and outside salespersons.

Family and Medical Leave Act

The Family and Medical Leave Act (FMLA), enacted in 1993, guarantees all eligible workers up to 12 weeks of unpaid leave during any 12-month period for family and medical emergencies. The FMLA applies to all public and private employers with 50 or more employees, covers employees who have worked for the employer for at least one year, and applies to employees who have worked at least 25 hours a week for each of 12 months prior to the leave. The events that qualify workers for leave are:

- The birth of a child
- The adoption of a child
- The placement of a foster child in the employee's care
- The care of a seriously ill spouse, parent, or child
- Any serious health condition that prevents the worker from being able to perform any of the essential functions of the job

Once the employee returns to work, he or she must be restored to the same or equivalent position. Social Security benefits also provide benefits to certain employees and their dependents. The types of benefits that fall under Social Security regulations include disability benefits, Medicare benefits, survivors' benefits, and retirement benefits.

Ending Employment

There are also several regulations that cover workers who are terminated or who lose their employment. These are summarized in the following table.

Table 6.1.2

Regulation	Description
Consolidated Omnibus Budget Reconciliation Act (COBRA)	Mandates that employees who are terminated must be provided with the opportunity to continue to participate in group health insurance, so long as they agree to pay the group rate premium. The employer is required to notify employees of their COBRA rights.
Employee Retirement Income Security Act (ERISA)	This Act covers any pension plan offered by employers to their workers, and is designed to prevent abuses and fraudulent use of those plans. Under the terms of ERISA, employers are required to keep certain records pertaining to the plans and to report on those records at regular intervals. The Act also provides for vesting , which occurs when an employee has a non-forfeitable right to receive pension benefits.
Unemployment compensation	Unemployment compensation programs are paid to those who become temporarily unemployed, and are funded by employers through employment taxes. Workers who quit voluntarily or who are terminated for bad conduct are not eligible for compensation. In addition, in order to qualify for the benefits, applicants must demonstrate that they are available for work.

Immigration Law

Immigration law intersects with employment in numerous ways. U.S. Citizenship and Immigration Services (**USCIS**) administers employment-based immigration benefit programs, while Immigration and Customs Enforcement (**ICE**) oversees worksite enforcement. Employment-based immigrant classifications, such as the EB-1 Visa, allow qualifying foreign nationals, such as individuals with **extraordinary ability, outstanding researchers, and multinational executives**, to obtain lawful permanent residence, in some cases without employer sponsorship. Under the Immigration Reform and Control Act (**IRCA**), employers must verify the identity and employment authorization of all new hires by completing Form I-9 and complying with evolving verification procedures. Employers face significant civil and criminal penalties for knowingly employing unauthorized workers, as well as liability for discrimination based on citizenship or national origin.

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6.2: Labor Law

Labor relations is the general term used to describe the relationship between employers and employees, as well as the governance of that relationship. It refers to the micro-level interactions that take place between workers and individual managers, as well as the macro-level relations that occur between the external institutions that are tasked with governing such relations. This understanding of labor relations acknowledges the fact that there is a plurality of interests that must be taken into account in the processes and procedures of negotiation, bargaining, and dispute settlement relating to the workplace. It also recognizes that employees and employers' representatives are fundamental to the process of industrial relations, and that the state plays a key role in the development of labor laws, the regulation of collective bargaining, and the administration of disputes. There has been considerable flux and development in the nature of U.S. labor over the past century. However, the most substantial changes have occurred since the 1950s. Changes have been particularly evident in the role that the state has been expected to play in employment relations between workers, their representatives, and their employers. This section introduces some of the key milestones in labor relations in the United States and describes the role played by **trade unions** in governing the relationship between employers and employees.

What Is a Trade Union?

A trade union, or labor union, is an organized group of workers who come together to lobby employers about conditions affecting their work. There currently are around 60 unions representing 14 million workers across the United States. Unions are organized according to the type of work that workers do. For example, the American Federation of Teachers is the labor union for teaching personnel, while the International Association of Fire Fighters covers firefighters. Many unions in the United States are organized as **local unions**. This type of union is a locally (i.e., company or region) based group of workers who organize under a charter from a national union. For example, Affiliated Property Craftspersons Local 44 is the Los Angeles union of entertainment professional craftspersons, chartered under the International Alliance of Theatrical Stage Employees.

Timeline of Developments in Labor Law

- **1886.** The American Federation of Labor was formed in Columbus, Ohio. This group was a national federation of labor unions that came together to bolster their power in industrial unionism. The AFL was the largest union grouping in the United States well into the twentieth century. However, the Federation was craft-dominated, such that only craft workers like artisans and silversmiths were allowed to belong.
- **1932.** The Norris-LaGuardia Act was passed. This Act prohibited **yellow-dog contracts**, or contracts that prevented workers from joining labor unions. In addition, federal courts were barred from issuing injunctions to prevent groups of workers from engaging in boycotts, strikes, and picketing.
- **1935.** The Congress of Industrial Organizations was established. This establishment extended the union movement because it allowed semi-skilled and unskilled workers to become members.
- **1935.** The Wagner Act, or **National Labor Relations Act**, was passed. This Act is the major statute of United States labor law. The Act established that employees have the right to form, assist, and join labor organizations, to engage in collective bargaining with employers, and to engage in concerted activity to promote those rights.
- **1947.** The Labor-Management Relations Act, also known as the Taft-Hartley Act, imposed restrictions on the power of labor unions. It made changes to union election rules and outlined and provided remedies for six unfair practices by labor unions (see box below).
- **1959.** The Labor Management Reporting and Disclosure Act, or Landrum-Griffin Act, was passed, which regulates the internal affairs of trade unions, as well as their officials' relationships with employers. All union members are granted equal rights to vote for candidates, take part in membership meetings, and nominate candidates for office.
- **1988.** The Worker Adjustment and Retraining Notification (WARN) Act requires that employers with more than 100 employees give workers at least 60 days' notice before engaging in layoffs or plant closings.

Amendments to the Taft Hartley Act

Below is a list of each amendment and what it does.

1. Protects employees from unfair coercion by unions that could lead to discrimination against employees.

2. States that employers cannot refuse to hire prospective workers because they refuse to join a union. This amendment also grants the employer the right to sign an agreement with a union that requires the employee to join the union before the employee's 30th day of employment.
3. Unions must bargain in good faith with employers.
4. Prevents unions from engaging in secondary boycotts.
5. Prevents unions from taking advantage of either employers or members. For example, unions cannot charge members excessive membership dues or cause employers to pay for work that has not been performed.
6. Grants employers the right to free speech. Expressed opinions about labor issues do not constitute unfair labor practices, as long as the employer does not threaten to withhold benefits from, or engage in, retribution against the worker.

The National Labor Relations Board

The National Labor Relations Board (NLRB) was established to administer, interpret, and enforce the terms of the National Labor Relations Act. It has jurisdiction over all workers, except for government employees and employees in the transportation industry, who are governed under a separate statute (The Railway Labor Act). Other workers not covered by the NLRB include agricultural workers, confidential employees (employees who develop or present management's position or who have access to confidential information related to bargaining employees), independent contractors, and those employed by a spouse or a parent. The NLRB has three main functions:

1. To monitor the conduct of unions and employers during elections to determine whether employees wish to be represented by a union
2. To remedy and prevent unfair labor practices by unions or employers
3. To establish rules interpreting the NLRA



Figure 6.2.1: Under the terms of the National Labor Relations Act, employees have the right to strike as part of their efforts to secure better working conditions. (Credit: Geralt/ pixabay/ License: CC0)

Organizing a Union

For a union to be formed and organized, the union must identify an **appropriate bargaining unit**. This term is used to describe the group of workers that the union is looking to represent. Under the terms of the **inaccessibility exception**, employees and union officials have the right to engage in union solicitation on the firm's property if they cannot otherwise access employees to communicate with them. The next stage is to run an election. There are three types of elections:

- **Consent election.** This election is held when there are no substantial issues under dispute between the union and the employer. Both parties agree to waive the pre-election hearing.
- **Contest election.** This election is for a union that is contested by the employer. The NLRB is required to supervise this kind of election.
- A **decertification election** is held when employees indicate that they wish to vote out the union or join another.

In order to try to bolster their power, elected unions often attempt to install a **union security agreement**. This agreement pertains to the extent to which the union can demand that employees join the union, and whether the employer will be required to collect fees and dues on behalf of the union. A **closed shop** is a workplace where union membership is a requirement for employment. A **union shop** is a place of employment where the employee is required to join the union within a specified number of days after being hired. An **agency shop** is a workplace that does not require the employee to join the union, but where agency fees to the union must be paid. Union security agreements are the outcome of collective bargaining agreements.

Collective Bargaining

Collective bargaining involves the union and the employer negotiating contract terms. The outcome is known as a **collective bargaining agreement**. The types of terms that are usually negotiated are wages and salaries, hours, and the terms and conditions of employment. If union members dispute working conditions, unfair labor practices, or economic benefits, they have the right to participate in a cessation of work activities, known as a **strike**. There is a mandatory cooling-off period of sixty days before a strike can commence. Some collective bargaining agreements include no-strike clauses. Although strikes are permitted according to the NLRBA, some strikes are illegal:

- Violent strikes
- Sit-down strikes
- Wildcat (unauthorized) strikes
- Intermittent, or partial strikes

In addition to striking, union members have the right to picket. This process involves walking in front of the employer's premises with signs that advertise the strike and the union's demands. Picketing is lawful as long as it does not:

- Involve violence
- Prevent customers from entering the premises
- Prevent non-striking workers from entering the premises
- Prevent the business from receiving deliveries or pickups

Secondary boycott picketing occurs when the union pickets the employer's customers or suppliers. This type of picketing is legal if it is product picketing, but illegal if the picket is directed against a neutral business.

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6.3: Equal Employment Opportunity

A Landmark Case

In 1982, the financial services company Price Waterhouse announced a vacancy for the position of partner. Ann Hopkins, an employee of the company at the time, applied, but after an assessment, was passed over. Hopkins sued the company, arguing that she had billed more than \$34 million in consulting contracts for the firm, far more than any of the other 87 candidates, who were all male. In rejecting her application, the partners at the company argued that Hopkins was “too macho” and that she should “walk more femininely, talk more femininely, dress more femininely, wear makeup, have her hair styled, and wear jewelry.” In the landmark legal suit that followed, Hopkins was awarded \$371,000 in back pay, and Price Waterhouse was forced to make her a partner.

Laws Governing Equal Opportunity in Employment

Employees are protected in the workplace by a number of laws enacted at both the federal and state levels. Federal laws are usually considered to be the minimum level of protection, and state laws can provide employees with more, but not less, protection. In this section, the major laws pertaining to equal opportunity are discussed.

Civil Rights Act of 1964 – Title VII (Amended By the Civil Rights Act of 1991)

The Civil Rights Act provides broad provisions pertaining to citizens’ civil rights. Title VII of the Civil Rights Act deals with discrimination in employment. It bans employers from discriminating against employees in their hiring, firing, and promotion practices on the basis of sex, national origin, color, religion, or race. All employers who are engaged in commercial activity and who employ 15 or more employees for 20 consecutive weeks in a year are covered by the Act. The Act also sets out the two main ways in which discrimination can be proven: disparate treatment and disparate impact.

Disparate treatment means that the employee believes that he or she has been discriminated against on the basis of one of the protected classes set out in the CRA. Proving that the employer engaged in disparate treatment is a three-step process:

1. The employee (plaintiff) is required to demonstrate a **prima facie** (accepted as correct unless proven otherwise) case of discrimination.
2. The employer (defendant) must show legitimate, non-discriminatory business reasons for undertaking the action.
3. The employee must demonstrate that the reason given by the employer is a mere pretext.

A trier of fact, usually a jury, will use the evidence presented to determine whether discrimination did in fact occur. If the jury finds for the employee-plaintiff, damages can be awarded, as occurred in the landmark Ann Hopkins case, described in the opening box. If the jury finds for the employer-defendant, no damages are assessed.

Damages Permissible Under Title VII of the CRA

- Up to two years of back pay
- Compensatory damages
- Punitive damages
- Remedial seniority
- Costs (e.g., attorney fees and court cases)
- Court orders (e.g., reinstatement)

Disparate impact cases are cases of unintentional discrimination. This type of case occurs when the employer engages in a practice that has a disproportionately injurious impact on a protected class. Disparate impact cases are difficult to prove. The burden of responsibility is on the employee-plaintiff to statistically establish that the action impacts the protected class. The defendant can avoid liability by demonstrating that the practice is a business responsibility. The burden of proof then shifts to the employee to prove that the alleged business necessity is a mere pretext. These steps were established in *Griggs v. Duke Power Co.* Duke Power required all job applicants to have a high school diploma and to reach a certain minimum score on a professional intelligence test. Willie Griggs, the plaintiff, established that the rule was racially discriminatory because only 12 percent of black men in the state had high school diplomas (compared to 34 percent of white men), and only 6 percent of blacks had passed similar

intelligence tests, compared to 58 percent of whites. Duke Power tried to argue that the provisions were necessary to upgrade the quality of the workforce, but the court did not agree that this defense was an adequate business-related justification, and the plaintiff was successful.

In recent years, the disparate impact framework has remained part of Title VII doctrine, but its practical enforcement has shifted, creating a more complex environment for businesses. Federal agencies have issued guidance explaining that neutral tools such as pre-employment tests, algorithmic screening, or AI-driven hiring systems can create unlawful disparate impact if they disproportionately exclude a protected group and are not demonstrably job-related and consistent with business necessity. At the same time, recent federal policy has directed the EEOC to scale back or close many investigations based **solely** on disparate impact, which may reduce some regulatory oversight but does not eliminate employers' potential liability in **private litigation**. For businesses, these developments increase the importance of proactively auditing hiring, promotion, and discipline practices for statistical disparities, documenting the business necessity and job-relatedness of key criteria, and reassessing or replacing selection procedures, especially AI- and data-driven tools, when less discriminatory, equally effective alternatives are available.



Figure 6.3.1: Employees are protected against discrimination by employers by a number of laws enacted at both the federal and state level. (Credit: Wokandapix/ pixabay/ License: CC0)

Sexual harassment is also protected under Title VII. This type of harassment is defined as unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature. Two types of sexual harassment are recognized. **Quid pro quo** occurs when a manager makes a sexual demand on a worker, and this demand is perceived as a condition of employment. Actions that create a **hostile work environment** are another type of sexual harassment. These issues have been used in cases of discrimination based on race and religion, as well as sex. Since the 1997 case *Oncale v. Sundowner Offshore Services Inc.*, it has been established that sexual harassment undertaken by a member of one sex against a member of the same sex is actionable under Title VII. In some limited circumstances, employers may also be liable for harassment of employees by non-employees, e.g., customers. The employer is liable if it does nothing to prevent and remedy harassment targeted at one of its employees. **The Pregnancy Discrimination Act** of 1987 expanded the definition of sex discrimination to include discrimination based on pregnancy, childbirth, or medical conditions related to the same.

Defenses to Title VII Claims

Table 6.3.2

Defense	Description
The Bona Fide Occupational Qualification Defense (BFOQ)	Using this defense, the employer can discriminate if it is deemed to be necessary for the performance of the job. Necessity, however, must be determined on the basis of actual qualifications, rather than stereotypes about the abilities of a certain class. For example, an employer is not expected to hire a man as a model for women's clothes. Hires on the basis of sexual privacy are covered under BFOQ. However, there are no BFOQs for discrimination on the basis of race or color.
The Merit Defense	This defense is used when decisions pertaining to hiring or promotion are made on the basis of the results of test scores. However, tests must be validated in accordance with professional standards and must be manifestly related to job performance.
The Seniority Defense System	This defense system occurs when employees are given preferential treatment because of their length of tenure. As long as the system does not have its genesis in discrimination, and is not used to discriminate, and applies to all persons equally, it is lawful.

The Equal Pay Act

The Equal Pay Act (EPA) is a United States federal law that seeks to equalize the salaries and wages paid to employed women with the levels paid to men for work of an equal nature and quantity. The Act amended the Fair Labor Standards Act of 1938 and was a key element of President F. Kennedy's New Frontier program. Under the terms of the EPA, women and men performing jobs that demand "equal skill, effort, and responsibility, and which are performed under similar working conditions" must be paid the same. The Act protects the rights of both sexes. An individual who seeks to establish a case under the Act must demonstrate that:

1. An employer pays one sex more than the other.
2. Both sexes perform an equal amount of work that demands equal levels of skill, effort, and responsibility.
3. Working conditions for both sexes are equivalent.

An employer that is accused of discrimination under the EPA can present one of four **affirmative defenses**. An employer may legally pay employees of one sex more than another sex if wages are based on a system of seniority, a system of merit, a system that distinguishes payment on the basis of quality and quantity of production (e.g., certain piece rates), or if payment is differentiated on "any other factor other than sex." Of these four defenses, the "factor other than sex" defense has been invoked most frequently and has been the subject of intense debate and controversy. Critics have argued that this defense enables employers to fabricate other reasons for the wage gap.

The Lilly Ledbetter Fair Pay Act

In 2009, President Barack Obama signed the Lilly Ledbetter Fair Pay Act as the first bill of his presidency, underscoring the federal government's commitment to strengthening remedies for pay discrimination. The Lilly Ledbetter Fair Pay Act of 2009 strengthened federal pay-discrimination protections by changing how the statute of limitations is calculated for compensation claims under Title VII, the ADEA, the ADA, and the Rehabilitation Act. In a 2007 decision, the U.S. Supreme Court held that the filing period began when the employer first made a discriminatory pay decision, even if the unequal pay continued for years afterward, which made many claims time-barred before employees realistically could discover the disparity. The Ledbetter Act overturned that ruling by providing that an unlawful employment practice occurs each time an employee receives a paycheck (or other compensation) affected by an earlier discriminatory decision, so the 180- or 300-day charge-filing period resets with each discriminatory paycheck. For businesses, the Act increases exposure to long-running pay claims and therefore places a premium on maintaining detailed compensation records, conducting regular pay-equity reviews, and applying compensation systems (such as merit, seniority, or productivity plans) consistently and in a well-documented, nondiscriminatory manner.

Americans with Disabilities Act

The Americans with Disabilities Act (ADA) prevents employers from discriminating against workers on the basis of their physical or mental disabilities. In addition, employers are required to make reasonable accommodations to known disabilities, as long as such accommodations do not impose an undue burden on the business. To bring a successful ADA claim, the plaintiff is required to demonstrate that he or she:

- Has a disability
- Suffered an adverse employment decision because of that disability
- Was otherwise qualified for the position

ADA is enforced in a similar way to Title VII, and remedies for ADA violations are also similar.

Age Discrimination Act

Passed in 1967, this Act prohibits employers from making discriminatory employment decisions against people age 40 or older. This Act applies to all employers with 20 or more employees.

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CHAPTER OVERVIEW

7: The Property System

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[7.2: Personal Property](#)

[7.3: Real Property](#)

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7.1: Introduction to Property Law

Learning Objectives

After reading this section, you should understand different classifications of property, including personal property and real property, as well as different types of interests in real property. You will also learn about methods of acquisition and transfer of real property. At the conclusion of this section, you should be able to answer the following questions:

- What is the difference between real property and personal property?
- How is ownership interest in personal property transferred?
- What interests in real property exist?
- How is real property acquired and transferred?
- What legal relationships exist between landlord and tenants?

The concepts of property and ownership are fundamental to any society. Property refers to tangible and intangible items that can be owned. Ownership is a concept that means the right to exclude others. Disputes over both have been at the root of conflicts and wars since time immemorial. Without laws to protect property ownership, the stability of our society would be seriously undermined. For example, if the law did not protect ownership interests in property, then people would have to protect their property themselves. This means that people would have to hire their own security forces to protect their property, or they would have to stand guard over their property personally. It would be difficult to get anything else done. Such a system would likely result in the development of powerful factions. Those with the greatest power would dominate property ownership, and weaker members of society would be at their mercy. For example, one of the opening scenes of the movie *Black Hawk Down* illustrates a U.N. food distribution point in Mogadishu, Somalia. As depicted in that scene, people were waiting to receive the distribution of food, but a powerful, armed faction seized the cargo and opened fire on them. Obviously, such a system of property ownership would prove to be very unsettling, and it would lead to great instability in our economic system.

Our legal system creates a peaceful means to acquire, retain, and divest of property, and to settle property disputes. It punishes those who operate outside of those rules. Indeed, those who do not acquire property lawfully or who do not settle property disputes within the confines of our legal system are subjected to criminal and civil penalties.

In the United States, our legal system ensures the ability to own property for everyone that the system recognizes can own property. Of course, not everyone has always been able to own property. The history of the United States is replete with examples of exclusion from the property ownership system. For example, at various times and in different ways, married women, African Americans, and people of Chinese and Japanese descent have been subject to restrictions regarding the ownership of real property. Because property law is a state law issue, those restrictions and exclusions vary from state to state. Today, no such restrictions exist. Indeed, even a nonhuman legal person, such as a corporation, can own property. However, some biological beings cannot own property. For example, nonhuman animals cannot own real or personal property in our legal system. This is because nonhuman animals are not legal persons. However, a nonhuman animal can be a beneficiary of a trust in many states.

Moreover, not everything is subject to ownership. For instance, the human body cannot be owned by another, though historically, in legal systems that recognized slavery, certain human bodies could be owned. Today, public policy discourages the treatment of the human body as personal property, rendering “gifts” of body parts to specific individuals largely suspect. For example, organ donees may have a need for an organ destined for transplant into their own bodies after the donor’s body dies, but they do not have a legal right to it. *Colavito v. New York Organ Donor Network*, 2006 NY Slip Op. 09320 (NY App. Ct. 2006). Similarly, the question regarding whether human genes may be owned through a patent is a hot topic. Check out "[When DNA Is Isolated from the Human Body, Is It Subject to Ownership by Patent?](#)" and consider whether the benefits of patentability of certain body parts, like genes, might outstrip the concerns surrounding ownership of the human body.

Before engaging in questions regarding the evolution of property ownership rights, it is necessary to lay the foundation for studying this fascinating area of law. It is this foundation to which we now turn. This chapter explores the differences between real and personal property, and the acquisition, transfer, and protection of real and personal property interests. Additionally, it examines different interests in real property.

Key Takeaways

The U.S. legal system protects the rights to own, acquire, protect, and divest of real and personal property. These protections are necessary for a peaceful civil society. Historically, different groups of people have been subjected to discriminatory practices—both legal and illegal—regarding property ownership. Today, legal persons can own, acquire, transfer, and sell property. However, not everything is subject to property ownership concepts.

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7.2: Personal Property

Learning Objectives

- Distinguish between personal property and real property.
- Understand classifications of property.
- Examine methods of acquisition of personal property.
- Understand the concept of bailment and the legal duties associated with bailment.

Let's begin with an understanding of the differences between types of property. This is important because different laws apply to different types of property. While it might be perfectly legal to destroy a piece of personal property—like a chair—without obtaining permission from the government, destruction of real property is a different matter altogether. For example, the owner of an office building who wishes to demolish it would be subject to many local laws, such as requirements to obtain the necessary permits. Such an activity might also be subject to further legal scrutiny if the building in question holds particular historic value, for example. Let's compare this to the destruction of a chair, which is personal property. Even if the chair is the chair that Abraham Lincoln sat in while drafting the Emancipation Proclamation, as long as the chair is owned by the person who wishes to destroy it, the owner may simply load it into his or her truck and haul it to the dump. No special permission is required because there are few legal restrictions on the destruction of private property.

As you can see, property can be classified as real or personal. Real property is land and certain things that are attached to it or associated with it. Real property is raw land, such as a forest or a field, as well as buildings, like a house, a condominium, or an office building. Additionally, things that are associated with land, like mineral rights, are also real property. People often talk about real property by using the term real estate, which reflects both the concept of real property and the concept of ownership interest.

Many businesses, from grocery stores to coffee shops to hotels, rely on real property for customers or clients to visit to conduct business. Today, many businesses are also conducted virtually, and have only virtual shops. Virtual stores, such as those found on eBay, are *not* forms of real property. However, certain virtual real properties, such as those found on Second Life, are traded for real money.

Personal property is property that is not real property. Tangible property is something that can be touched. Moveable, tangible personal property is chattel. Many businesses exist to sell personal property. For example, the primary purpose of retailers such as Wal-Mart, Amazon.com, and Sears is to sell personal property. Some property can also be described as fungible property. Property that can easily be substituted with identical property is said to be fungible. For example, if you bought a pound of sugar from a container containing ten pounds of sugar, you wouldn't care which specific grains of sugar made up your purchase, because all the sugar in the container is fungible. Other types of fungible goods include juices, oil, metals such as steel or aluminum, and physical monetary currency.

Some personal property is intangible. Intangible property does not physically exist, but it is still subject to ownership principles, including acquisition, transfer, and sale. For instance, the right to payment under a contract, the right to exclude others from a patented product, and the right to prohibit others from using copyrighted materials are all examples of intangible property.

Sounds simple, right? Your iPod, your flash drive, and your computer are all personal property. Your dorm room, apartment, or house is real property. So far, so good. But imagine that you found a Jacuzzi for sale that you loved. You plunked down \$5,000 to buy it, and you have it delivered to your house. You pay for the construction of a deck to surround it and plumbing to service it. Is the Jacuzzi personal property or is it real property? This is an example of personal property that becomes attached to the land as a fixture. A fixture is something that used to be personal property, but it has become attached to the land so that it is legally a part of the land. Fixtures are treated like real property. Accordingly, when real property is transferred, fixtures are transferred as a part of the real property. In our example, if you move, you will have to leave your beloved Jacuzzi behind, unless you make express provisions to remove it. What if you were just renting? Since removing a fixture would cause substantial harm to the property, that fixture remains with the land. The landlord might be very happy about that!

Some things that are attached to the land are not fixtures but are part of the real property itself. Imagine a farm with one thousand acres planted in corn. Is the corn crop personal property, or is it real property? Or imagine a forest. Maybe the owner has been thinking about timbering the forest for some extra money. Is the forest personal property, or is it real property? Both the corn crop

and trees are examples of real property that can become personal property if they are severed from the land. This means that when an ear of corn is picked from the stalk, the ear of corn becomes personal property, even though while it was growing and still attached to the land, it was real property. Likewise, when a tree is felled, that tree is transformed from real property to personal property.

Besides property *types*, property can be classified by *ownership*, too. Personal property and real property can be private or public. Private property is owned by someone or something that is not the government. Individuals, corporations, and partnerships, for instance, can own private property. Private property can include real property like land or buildings, and personal property, such as automobiles, furniture, and computers. Property that is owned by the government is public property. Yellowstone National Park and the Gifford Pinchot National Forest are both examples of public property that is real property. Public property can also include personal property, such as automobiles, furniture, and computers owned by state or local governments.

Methods of Acquisition of Personal Property

Personal property may be acquired for ownership in several different ways. For example, if you produce something, then you may own it, unless you are producing it in the capacity of your work for someone else. If you buy four yards of wool fabric and sew a coat out of it, then you own that coat by virtue of having produced it with your own materials. This is ownership by production. However, if you sew a coat as part of your job while working for your employer, then the employer will own the coat.

If you are in the business of producing coats to sell, then you may be a merchant, and the rules of the Uniform Commercial Code (UCC) would govern transactions involving the sale of goods and the purchase of supplies from other merchants. Regardless of whether someone is a merchant or not, a purchase is a means of acquiring ownership. Indeed, in today's world, purchase may be the most common method of acquiring property.

Property may also be gifted. A gift is a voluntary transfer of property. Generally, the donor of the gift must intend to gift the property, the donor must deliver the gift, and the gift must be accepted by the intended recipient, known as the donee. A conditional gift is a gift that requires a condition to be met before the gift will transfer. For example, if your parents said, "You can have a new car if you graduate from school," then that would be an example of a conditional gift. If you do not graduate from school, then you cannot have the gift of the car.

What if you find something? Dating at least to the Institutes of Justinian in Roman law, the concept of "finders keepers" is one known to every preschooler: *finders keepers, losers weepers*. However, in law, things are not quite so simple. Property that someone finds can be classified in several ways. A finder of personal property may claim ownership of the property if it is abandoned. The owners of abandoned property must intend to relinquish ownership of it. For example, if you take your chair to the landfill, you have abandoned the chair. Someone may come along and take possession of it, which will place ownership of the chair in that person. If you change your mind later, that's too bad. The chair now belongs to the new owner. However, if the property is simply lost or mislaid, then the finder must relinquish it once the rightful owner demands its return. If the finder refuses to return lost or mislaid property to its rightful owner, the owner can sue for conversion, which is a tort. Conversion is intentional, substantial interference with the chattel of another. Another classification of personal property applicable to found property is treasure trove. A treasure trove is money or precious metals, like gold, for which the concept of "finders keepers" sometimes is applicable.

Imagine finding the next-generation iPhone just lying on a barstool. It has not been released yet, but there you are with an actual prototype in your hands! This is a valuable property because it embodies the cutting-edge intellectual property of Apple, both in utility and design. Brian Hogan found himself in this position. Apparently, an Apple software engineer had accidentally left the prototype on a barstool one evening. Hogan decided to sell the prototype to Gizmodo, a tech site, which was willing to pay for it so that it could write an early and exclusive review of this soon-to-be hot item on the market. Gizmodo subsequently discovered that Apple had lost an iPhone prototype and wanted it returned. Regardless of that fact, Gizmodo dismantled the prototype and published photos on its website. Subsequently, it returned the property to Apple. Edward C. Baig, "[Gizmodo: Lost Next-Gen iPhone Returned to Apple](#)," *USA Today*, April 21, 2010.

Was the prototype of the next-generation iPhone abandoned, lost, mislaid, or a treasure trove? If Apple filed a civil lawsuit against Gizmodo, what would the claim be, and who should win? Since we know that Apple wanted the property back, we know that it had no intention of relinquishing ownership of it. Therefore, the property was not abandoned. Since a next-generation iPhone is not

money or precious metals—even though it is very valuable and worth a lot of money to Apple—the concept of treasure trove does not apply. A phone is not an actual coin or cash. In this case, the property was either lost or mislaid because it was unintentionally relinquished or set down for later retrieval, but the owner had forgotten where it was placed. In either case, if the phone had not been returned, Apple could have brought a suit for conversion. A successful conversion claim would have awarded damages to Apple. Just like any successful conversion claim, damages would not include a requirement to return the property itself. Incidentally, California has captured the duty to return lost or mislaid property in its criminal statutes, and the facts of this case are being investigated for possible theft charges. Check out "Learn More: Finders Keepers?" for this story and an additional cautionary tale about claiming found property.

Learn More: Finders Keepers?

Be careful what you wish for. These stories might seem like a miracle to the cash-strapped, but they are cautionary tales.

[Next-Generation iPhone](#)

Gizmodo [published the details of a found iPhone prototype](#), but the prototype became the subject of law enforcement and an [Apple complaint](#).

[A Renovator's Fantasy](#)

This found money in the walls of a house might be an example of a treasure trove, but the treasure was quickly dissipated by [legal troubles](#) and [the epilogue](#).

Bailment

Sometimes it is necessary to intentionally leave personal property with someone else. For example, imagine that you own a cat. If your cat, which is considered to be chattel, needs to have surgery, you will need to leave her at the veterinary hospital. Clearly, taking your cat to a veterinary hospital does not constitute abandonment. Likewise, you have not lost or mislaid your cat. And, precious though she may be, your cat is not subject to the concept of treasure trove. Instead, in this situation, you will be known as the bailor, and you will be seeking a bailment with your veterinarian. A bailor is someone in the rightful possession of personal property who gives the property to someone else to hold. A bailment is the arrangement in which the rightful possessor (such as the owner) of personal property gives the property to someone else to hold. The holding party, known as the bailee, agrees to accept the property and has the duty to return it. The bailee is someone who is in possession of someone else's property. In our example, you rightfully have possession of your cat because she is your personal property. You give your cat to the veterinarian to hold, who has agreed to accept the cat. You also rightfully expect that the cat will be returned to you on demand. Indeed, the veterinarian has a duty, by virtue of the bailment, to return the cat to you. Consider "Learn More: Lost Dog", where Delta Airlines was the bailee of a dog, which it lost.

Learn More: Lost Dog

Check out this [story about a Delta Airlines and a lost dog](#). Do you think the remedy offered by Delta Airlines is adequate in this case? Why or why not?

The bailee has certain duties to the bailor. For example, a bailee has a duty to take reasonable care of the property while the property is in his or her possession. This means different things for different types of bailment. If the bailee is the only party who benefits from the bailment, then the bailee must take extraordinary care with the personal property. A common example of a bailee being the only party who benefits is where the owner of the property loans the property to someone for his or her use. For instance, if you loan your neighbor a snow shovel without asking for something in return, then your neighbor receives the sole benefit of the bailment. His or her duty of care is that he or she must take extraordinary care with the snow shovel. However, when both parties receive benefit from the bailment, such as when you rent something from a store, only the duty of ordinary care is imposed on the bailee. The bailee receives the item, and the store receives a rental fee. When the benefit of the bailment exists for the benefit of the bailor only, then only minimum care is required. Gross negligence will give rise to liability, but there is no great duty for the bailee to be as careful as he or she would be if he or she were receiving some benefit. If someone asks you to hold his or her books while

he or she jumps into a swimming pool, you would have a minimum duty of care. If you lost the books, then you would not be liable. However, if you intentionally threw the books into the pool, then you would be grossly negligent and liable for damages.

An involuntary bailment is created when someone finds lost or mislaid property. The finder may not destroy the property, though the duties that he or she owes regarding the property may vary from state to state. A voluntary bailment is created when the intention exists to create the bailment, as described in the previous paragraph.

As you can imagine, bailment is common in business. Examples of bailment in business include placing packages or goods with common carriers for delivery, warehousing goods with a third party prior to sale or delivery, or taking clients' or customers' automobiles in a valet service. Consider whether a business should be able to disclaim bailment (and the duties that go along with bailment). For example, if a hotel required its guests to sign a "no bailment created" clause on check-in, should that excuse the hotel from liability if the guests' personal property is damaged while the property is left in the hotel?

Key Takeaways

Property is classified as real property or personal property, tangible or intangible, and private or public. Personal property can be transformed into real property when it is affixed to the land. Real property can be transformed into personal property when it is severed from the land. Personal property can be acquired for ownership through production, purchase, or gift, or, in certain circumstances, by finding it. Bailments are legal arrangements in which the rightful possessor of personal property leaves the property with someone else who agrees to hold it and return it on demand.

? Exercise 7.2.1

1. Classify the following as (1) personal property or real property, (2) tangible or intangible property, and (3) fungible property:
 1. A prosthetic device, for example, an artificial leg
 2. An expected inheritance of stock
 3. Draperies hanging in a dining room
 4. A bank account with a five-hundred-dollar balance
 5. A fictional story that you created
 6. A condominium on the thirty-second floor of a building in lower Manhattan
 7. The right to receive payment for your work (e.g., wages, salary)
 8. A wig that someone is wearing
 9. A silo filled with wheat
 10. The wheat in a silo
2. Would you be willing to pay real money for nonreal property in a virtual world like Second Life? Why or why not? What are people buying when they buy virtual real property? How does this differ from buying actual real property, like land?
3. If you found a prototype of the next-generation iPhone lying on a bar stool, what would you have done with it? What would be the consequences of your chosen action?
4. Think of an example of when you have asked for a bailment. Did you feel confident that you would receive your personal property when you demanded it? Did you worry that it would be damaged in any way? If it had been misdelivered, what would your legal remedies be?
5. Should bailees be permitted to disclaim liability for bailment agreements? Why or why not?
6. At major league baseball games, who do you think owns the baseball when it is being played, and who owns it when the ball enters the stands where members of the public sit? Who owns the ball if a member of the public picks it up?

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7.3: Real Property

Learning Objectives

- Understand the concept of real property.
- Examine methods of acquisition of real property.
- Understand different interests in real property, including ownership interests and the scope of interests.
- Examine the landlord-tenant relationship.

Real property is land, and certain things that are attached to it or associated with it. Real property includes undeveloped land, like a forest or a field, and it includes buildings, such as houses, condominiums, and office buildings. Real property also includes things associated with the land, like subsurface rights. Fixtures are personal property that have become attached to the land, and they are transferred with the land. Fixtures in a house include things like the lights affixed to the ceiling, the furnace, and the bathtub. Plants and trees that grow on the land are real property until they are severed from the land. For example, farmers' crops are part of their real property until they are separated from the land, at which time they become personal property.

Methods of Acquisition

Real property may be acquired for ownership (the title may be obtained) in one of several ways. It may be purchased, inherited, gifted, or even acquired through adverse possession. Ownership rights are transferred by title. Ownership of real property means that the owner has the right to possess the property, as well as the right to exclude others, within the boundaries of the law. If someone substantially interferes with your use and enjoyment of your real property, you may bring a claim in nuisance (a form of tort law). For example, if a neighbor decides to start burning tires on his property, the smell of the burning tires might substantially interfere with your use and enjoyment of your property, so you would have an actionable claim in nuisance. Similarly, if you own real property, you might rightfully seek damages against those who enter your land without your consent or permission. This would be a trespass to land claim. Owners of real property may also sell the real property, in whole or in part.

The most common way that real property is acquired is through purchase. Property law is a state law matter, and state laws vary regarding the conveyance of property. Typically, someone who is interested in acquiring real property will ask a third party, such as a real estate agent or a broker, to help locate a suitable property and to facilitate the terms of the deal. The buyer and seller will negotiate a contract, which will contain all essential terms of the sale, such as the location of the real property, price, fixtures that will be excluded from sale, and the type of ownership interest that is being transferred. Both parties will perform their promises under the contract (e.g., the buyer will pay the seller, and the seller will transfer the title via deed) to close the deal ("closing"), and then the deed will be recorded. A contract for any interest in property must be in writing to be valid against the defendant according to the Statute of Frauds.

Different types of deeds convey different types of interests. A quitclaim deed, for instance, conveys whatever interests in title that the grantor has in the property to the party to whom the quitclaim is given. Of course, that means if the grantor has no interests in the real property, a conveyance by quitclaim will not grant any interests in the property. For example, if you grant a quitclaim deed to your friend for the Empire State Building, then that means that you have transferred your interests in title to that building to your friend. If you have no interest in the title to the Empire State Building to begin with, then on conveyance of the quitclaim deed, your friend will not have any interests in the building either. You cannot convey interests that you do not have. On the other hand, many states allow a warranty deed, which conveys title and a warranty against defects in title as well as encumbrances. Buyers typically demand a warranty deed when they purchase property.

After the title is transferred by the deed, the deed is typically recorded. Recording the deed is not necessary for ownership. However, recording a deed to property is important because it places others on notice that whoever has recorded the deed to the property owns the property. Some states favor the rights of those who record the deed first (under a race statute), while other states favor the rights of those who acquired the interest first without notice of other claims to the property (under a notice statute). A race/notice system, which has a race/notice statute, is one in which priority is given to the first bona fide purchaser to record when there is a conflict in ownership claim. A bona fide purchaser is simply a purchaser who takes title in good faith, with no knowledge of competing claims to title.

Besides outright purchase, another common way in which real property may be obtained is through inheritance. Real property may be bequeathed through a will or may transfer per state statutes when a decedent dies intestate. Generally speaking, people have the right to dispose of their property as they wish when they die, providing that their will or other transfer instrument meets their state's requirements for validity. When someone dies intestate, state statutes will determine who among the decedent's relatives receives the property. For example, state statutes often specify that property will go to the spouse, and if there is no spouse, then to the children. If there are no children, then to the parents. If there are no living parents, then to the siblings, and so on. If no such person exists, the property may finally escheat to the state.

Real property may also be acquired through a gift. Providing that the person who is giving the property actually intends to make the gift of title, delivers the deed to the recipient, and the gift is accepted, then the gift is valid. If one of these elements is not met, for instance, if the deed is not delivered to the intended party (or to a third party to hold for the intended party), then the gift has not been successfully made, and the title will not be conveyed.

A less common way to acquire real property is through the doctrine of adverse possession. Colloquially, this is often referred to as "squatter's rights." At its heart, this method of acquiring property captures the deeply held belief that a land's value is in its use for profit. If a land sits idle at the owner's hands but someone else puts it to use, then the law may—just may—favor the user's claim to the land over that of the actual owner.

Adverse possession is when someone who is not the owner of real property has claimed the real property for their own. To be successful under this doctrine, several elements must be met. These include the following:

- The possessor must be in actual possession.
- The possession must be open and notorious, which means that it must be obvious to others (visible).
- The possession must be hostile, which means that it is against the actual owner's interests.
- The possession must be continuous, which means that the possessor cannot have been evicted during the statutory length of time required to obtain title through possession.
- The possession must be exclusive.
- The state statutory length of time must be met, and this time varies from state to state. For example, some states, like Maine, require a twenty-year period, while other states, like Nevada, require only a five-year period.

Some states' adverse possession laws also require that the possessor pay property taxes on the property during the course of the adverse possession. If all of these elements are met, then the possessor can bring a claim to quiet title. If successful, the possessor becomes the owner, without any compensation being made to the former owner.

Adverse possession and claims for quiet title often occur around property lines, where one party has routinely used another's property because a fence has been misplaced. Other instances involve claims concerning land owned by people who do not visit it, such as land owned in a remote area. Still, other examples exist in cases of ouster, when a tenant in common constructively or actually evicts others with valid ownership interests. Remember that all elements of an adverse possession must occur for the entire statutory length of time for an action for quiet title to be successful. This means, for instance, if the owner checks on the property and finds someone there, the owner must interfere with those elements. The owner should evict the trespasser, and this can be accomplished by summoning the police. Doing so would break the continuity requirement.

A recent case in Boulder, Colorado, prompted the Colorado legislature to substantially alter the state's adverse possession laws. In that case, a married couple, composed of a judge and an attorney, met the requirements for adverse possession and successfully brought an action for quiet title. In that case, the adverse possessors were clearly versed in the law. The actual owners of the property had purchased the land many years before to build a future retirement home. Check out "Learn More: A Question of Ethics" and see whether you think the Colorado legislature overreacted.

Learn More: A Question of Ethics

Is adverse possession [in this situation](#) a legally sanctioned form of theft?

Interests and Scope

Owning real property carries many responsibilities, as well as the potential for great profit and great liability. It is important to recognize the duties associated with property ownership and learn how to protect yourself against potential liability associated with it. For instance, if a toxic waste site is discovered on your real property, you may very well be liable for its cleanup, even if you did not realize that such a site was there when you purchased the land. Each buyer of real property has a duty to exercise due diligence when purchasing land. The idea is that you should have known about the site if it was discoverable on inspection. Knowing this, along with familiarity with the federal Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), helps us recognize that we should never agree to buy land “sight unseen,” or at least without a professional inspector that we trust. But what if an old toxic waste site is located on property that you wish to sell? You would have a duty to disclose such a defect in the land to prospective buyers before conveying ownership.

Additionally, we must consider the duties that landowners have to other people who enter the land. What are our duties to people who visit our home? Or our retail establishment? What if they are not invited but instead are trespassers? These duties of landowners will vary depending on the status of the person who was injured.

What if a gold mine were discovered on land that you used to own? Can you profit from that discovery? Probably not, if you conveyed full ownership to someone else.

As these examples illustrate, it is important to know about the *duties of landowners*, how to *limit liability* associated with the ownership of land, and when severance of liability occurs. These types of questions can be considered more fully when we consider ownership interests.

Additionally, it is important to know how an owner of real property may use the property, or the *scope* of his or her rights. Consider these questions: If you owned a lot in the middle of a city, can you build an apartment building that blocks the neighboring landowner’s light? Or if you own a piece of raw land where you discover oil, can you drill on your land if it siphons oil from underneath your neighbor’s land, or if it causes your neighbor’s land to collapse due to lack of subsurface support? If you live on a coastline and your neighbor builds a dyke that causes your waterfront property line to erode so that, over the years, your property is reduced in size, do you have an actionable claim against your neighbor? Conversely, if the ebb and flow of water along the coastline increases your property due to natural accretion, do you own the “new” property, even though it wasn’t part of the original purchase? Consider water disputes, which are a very hot topic in the western states. If you live next to a river, can you divert the entire stream of water, even if you wanted to divert it for a capricious reason? Imagine that you dreamed of having a very large private water park for your family, but you needed all the water in a river that adjoined your property to make that dream a reality. If you diverted all that water, other riparian owners might very well have an actionable claim. What if it were a drought year and you relied on water from a river to irrigate your commercial crops, but endangered salmon in the river needed the water for their habitat? Can you take the water for your crop, or must the water be left in the river for the endangered salmon? These types of legal questions can be addressed when we consider the scope of rights.

The following sections address the duties of landowners, ownership interests, and the scope of interest in real property.

Duties of Landowners

Landowners owe different duties to different types of people who enter their land. These responsibilities vary, depending on whether the person is a trespasser, a licensee, or an invitee.

A trespasser is a person who voluntarily and intentionally enters the land of another without permission or privilege. A landowner has a duty not to intentionally injure a trespasser. For instance, booby traps, pitfalls, or anything of the sort are simply not permitted. Trespassers injured by such a trap have valid claims against the landowner for injuries.

A licensee is someone who has permission to be on the land. Landowners have a higher duty of care to such a person. Not only must a landowner not intentionally injure a licensee, but the landowner must also warn the licensee of known defects. For example, if a landowner knows that the steps to his or her porch are icy, he or she has a duty to warn a licensee—such as a visiting friend—that those steps are icy. Failure to do so may result in liability for the landowner.

An invitee is someone who has entered real property by invitation. Businesses have issued invitations to the public. Public places have issued invitations to the public. Anyone who arrives at the invitation of an owner is an invitee. Landowners must inspect their

property for defects, correct those defects when found, and warn invitees about such defects. This is why you will see a “caution” sign on the floor of a grocery store, after it has been mopped or after a liquid spill.

Ownership Interests in Real Property

Different types of interests may be owned in real property. For example, real property may be owned without restriction, subject only to local, state, and federal laws. Or ownership interests may be narrower, subject to conditions, the violation of which can lead to loss of those ownership interests.

The most complete ownership interest is represented by a fee simple absolute. The owner of property in fee simple absolute has the greatest ownership interest recognized by law. Generally, if someone wants to buy real property, he or she is looking to buy property in fee simple absolute.

Compare that with a defeasible fee. A fee simple defeasible is subject to a condition of ownership or to some future event. For instance, if you donated land to “the City of Nashville, so long as it is used as a public greenway,” then the land would be owned in defeasible fee by the City of Nashville, unless it decided to do something else with the land, besides maintain it as a public greenway. Once the condition is violated, the land would revert back to either the original owner or whoever owned the reversion interest, which is a future interest in real property.

Another ownership interest is a life estate. This interest is measured by the life of the owner in the life estate. If you wished to grant ownership rights in real property to your mother for the length of her life, but then expected the property to be returned to you upon her death, you might grant a life estate to her. Similarly, a common investment, known as a reverse mortgage, employs the concept of a life estate. A reverse mortgage is an arrangement where the purchaser of real property agrees to allow the seller of the property to retain possession of the property for a specified period of time (such as the remainder of his or her life) in exchange for the ability to purchase the property at today’s price. This can be an attractive investment if the investor believes that the value of the property will increase in the future and if the investor does not need immediate possession of the property. These arrangements essentially gamble on the life expectancies of the sellers of real property by granting life estates to them in the property. However, sometimes this backfires. Check out “Learn More: Reverse Mortgage” for an example of a seller who outlived her investor in such an arrangement.

Learn More: Reverse Mortgage

“In life, one sometimes makes bad deals,” said Jeanne Calment, the oldest living woman in history, concerning the investor who “[reverse mortgaged](#)” her apartment.

Sometimes, more than one owner owns an interest in the property. Several types of co-ownership interests are recognized in law. These ownership interests are important for matters of possession, right to transfer, right to profits from the land, and liability. For example, tenancy in common describes an ownership interest in which all owners have an undivided interest in the property, equal rights of possession, and a devisable interest. Compare this to a joint tenancy, which describes an ownership interest in which the surviving owner has the right of survivorship. Imagine that you own a gold mine with your partner, Frank. Would you rather have a tenancy in common or a joint tenancy? You would rather have a joint tenancy because if Frank dies, then his interest in the gold mine would vest in you, rather than in his heirs. After all, you may not want to be a partner with Frank’s grandson (or whoever), but that is exactly what might happen with tenancy in common. Similarly, a tenancy by the entirety includes the right of survivorship, but it can only occur between a husband and wife. This concept is recognized in some states, but not all states.

These different interests are created by specific wording in the instrument of conveyance. To create a tenancy in common, the language would be “To John and Frank,” if John and Frank were to be the co-owners. However, if a joint tenancy were intended, the conveyance would have to be more specific, like this: “To John and Frank, with rights of survivorship.” Note that John and Frank could not benefit from a tenancy by the entirety unless they lived in a state that recognized same-sex marriages, and unless they were, in fact, married. Moreover, such questions have not yet arisen in our courts because the legal concept of same-sex marriage is still nascent and, in many states, not yet recognized in law.

Note that a tenant in tenancy in common may sell or transfer his or her rights without seeking permission from his or her cotenant. Imagine that you owned a farm with your best friend. At first, you agree to engage only in organic farming practices. Later, your

friend wants to move to conventional farming practices. Since you do not want any part in the spraying of pesticides or herbicides on the land, you decide to sell your interests to someone else. Even if your friend opposes the sale, he or she cannot block it. This is because cotenants in a tenancy in common have the unilateral right to transfer their interests in property. Imagine, later, that someone working on that land becomes very sick from a pesticide sprayed there after you sold your interest. You would not be liable for any damages resulting from such an event, because your liability would be severed with the sale. Compare this to a joint tenancy, including tenancy by the entirety. To transfer one's interests, the consent and approval of the cotenant is required. In the case that joint tenants disagree about the use of the property or its disposal, the courts can step in to grant a partition of the land, which essentially results in separate parcels being granted to the individual tenants. This recasts the formerly joint tenants into adjacent landowners, and it allows them to dispose of or use their property as each sees fit, with no rights to the other's property.

Scope of Interests in Real Property

Scope of ownership matters because it is determinative of what can (or cannot) be done with the land. The surface of the land and the buildings that are attached to the land are implicitly included when most people contemplate the scope of ownership of real property. However, other interests can be parsed and conveyed separately, including subsurface or mineral rights, and the right to light or right to a view. Moreover, water rights are granted differently, depending on whether the property is in the western or the eastern United States. Additionally, easements and covenants grant certain rights to non-possessors of land.

Subsurface or mineral rights are rights to the substances beneath the actual surface of the land. If you are interested in drilling for oil, but you do not want to buy every piece of land where you might wish to speculate, then you probably are in the market to purchase or lease mineral rights. This would allow you the right to extract whatever you find under the surface of the land and sell it.

Water rights are determined in two different ways in the United States. Generally speaking, states east of the Mississippi River follow a riparian water rights doctrine, which means that those who live next to the water have a right to use the water. The water is shared among the riparian owners. In a quite different scheme, most Western states use the concept of prior appropriation, which grants rights to those who used those rights "first in time." Moreover, under this concept, the use must be beneficial, but the owner of the right need not be an adjacent landowner. This policy has led to some unnatural uses of land in western states, where water rights are highly valued due to the scarcity. For example, we see flourishing farmlands in extremely arid climates because the owners of the water rights want to make sure that they retain their prior appropriation rights to the water by putting it to beneficial use (e.g., crop irrigation). If water is not put to beneficial use under a prior appropriation doctrine, then those rights can be lost. Prior appropriation is basically a "use it or lose it" doctrine. Moreover, adjacent landowners in prior appropriation states may have no right whatsoever to use the water that runs through their land. Indeed, such an outcome is very common.

Easements and covenants are non-possessory interests in real property. An easement is created expressly or impliedly, and it generally gives people the right to use another's land for a particular purpose. For example, an easement for utility companies to enter onto the land of others is common. This allows the utility companies to maintain poles, power lines, cable lines, and so on. Other examples include a landlocked property having an easement across another piece of property for the purpose of a driveway, or an easement granted to the public to walk along the property of another to gain access to the shoreline.

A covenant is a voluntary restriction on the use of land. Common covenants are homeowners' associations' rules, which restrict the rights of the owners to use their land in certain ways, often for aesthetic purposes. For instance, such covenants might require houses subject to the covenant to be painted only in certain preapproved colors, or they might contain prohibitions against building swimming pools.

Some covenants and easements run with the land, which means that the restrictions will apply to subsequent owners of the real property. Whether a covenant or easement runs with the land depends on the type of interest granted.

Landlord-Tenant Relationships

A leasehold interest may be created in real property. For example, if you rent an apartment, house, or dormitory room from campus, you are a tenant with a leasehold interest. In such a relationship, you are the tenant and the property owner is the landlord. A leasehold is simply a possessory interest with certain rights and duties, which are typically specified in the lease agreement. For example, a tenant has the right to exclusive possession of the real property and the duty to follow the rules of occupancy set out by the landlord, and a landlord in a residential lease agreement has the right to be paid rent and the duty to ensure that the premises are

habitable. If one party does not perform under the lease as required, the other party may seek legal remedy. For example, if a tenant does not pay rent, then a landlord may lawfully evict the tenant from the premises, even if the term of the lease has not run. Like other interests in real property, leases generally must be in writing to be enforceable against the defendant.

Different types of tenancies may be created. The most common tenancies are probably tenancies for years and periodic tenancies. Tenancy for years is simply a tenancy that lasts for a particular, specified period of time. When you rent an apartment, you might sign a lease for nine months to reflect the school year. That would be a tenancy for years, even though the term of the lease is less than one year. A periodic tenancy, on the other hand, is a tenancy that simply runs for a particular period of time and then automatically renews if it is not terminated by the landlord or the tenant. For instance, a one-year lease may become a periodic tenancy if neither party terminates. Imagine that you had a one-year lease, but you did not move out at the end of the year, and the landlord continued to accept rent payments and took no action to terminate the lease. A new lease—for a one-year period of time—would be created. Less common types of tenancies are tenancy at will, which is a tenancy for no particular fixed period of time and subject to termination at will by either the landlord or the tenant, and tenancy at sufferance, which is a tenancy that occurs when a tenant remains on the property after the right of possession has ended and without the landlord's consent.

Tenancies may be created for residential purposes or commercial purposes. Commercial leases typically last for longer periods of time than residential leases. For example, it is not uncommon to hear about commercial leases that last five, ten, twenty-five, or even ninety-nine years. Many of the same responsibilities and duties exist with commercial leases, but there are some important differences. For example, a commercial tenant may demand that the landlord refuse to rent to a competitor of the tenant within the same building. For example, if a golf shop is located in a strip mall, it may require as a term in the lease that the landlord refrain from renting other retail space to a competitor golf shop within the same strip mall.

Lease interests are assignable unless those rights are expressly restricted by the lease agreement. This means that the rights conveyed by the lease, which is a contract, may be transferred to another party by assignment, unless an express restriction on assignment exists within the lease. You may have seen restrictions on assignment in your own residential lease in the form of a no-subletting clause. Commercial leases routinely contain a restriction on assignment without permission from the landlord.

Just as the owner of real property may sell any or all of his or her interests, any ownership interest in real property may also be leased. For example, someone who owns the subsurface rights of land may lease the right to drill for oil or gas to another.

Key Takeaways

Real property may be acquired by purchase, inheritance, gift, or adverse possession. Owners of property must know the breadth and limits of their ownership interests to understand their rights to profits derived from the land and their liability resulting from use of their land. Interests in land may be absolute, conditional, or for a period of time. Additionally, co-owners may have different rights, depending on their kind of ownership. The scope of interest in land may include surface and the buildings attached to it, while other interests may be severed and conveyed separately, such as subsurface rights and water rights. Easements and covenants in real property convey nonpossessory interests. Leasehold interests are possessory, non-ownership interests.

? Exercise 7.3.1

1. Do you agree that a land's value is only its profits? If not, what makes land valuable? Does it have an "inherent" value, which has nothing to do with human profit?
2. Consider this contemporary take on the tort of nuisance. Some Gulf Coast landowners filed a nuisance suit against power companies for emitting carbon, arguing that the carbon led to global warming, which then led to increased sea levels, which then led to Hurricane Katrina's unusual ferocity and strength. The district court dismissed the case, but a three-judge panel on the Fifth Circuit reversed, saying the landowners had standing to proceed and that the claim was justiciable. Do you think that this is a valid nuisance claim? Why or why not?
3. Do you think that adverse possession should be abolished? Why or why not? If you discovered a squatter on your land, what should you do to protect your title?
4. What type of due diligence can be performed to ensure that the property does not contain a buried toxic waste dump?
5. Classify the following as trespasser, licensee, or invitee to determine the duty owed by a landowner:
 1. The mailman
 2. A customer in Wal-Mart

3. A person who cuts across your land to reach the other side, without your permission
6. Think of a situation in which you would grant a life estate to someone in property that you own. How does that situation differ from renting property to a tenant?
7. Find a story in the newspaper about liability resulting from the ownership of real property. Do you think that the landowner should be liable in the case that you located? Why or why not?
8. What benefits can you see for both the landlord and the tenant for extremely long leases? What are the risks?

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CHAPTER OVERVIEW

8: Intellectual Property

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8.1: Introduction to Intellectual Property

Learning Objectives

No matter what industry a company operates in, or its size, a company's intellectual property is often more valuable than its physical assets. While factories and inventory can be rebuilt after a loss, losing control of intellectual property can be ruinous for companies. After reading this chapter, you should be able to apply intellectual property concepts to answer the following questions:

- Why is it important for the law to protect intellectual property?
- Under what authority does Congress regulate intellectual property?
- How can intellectual property be protected?
- What are the differences between the major forms of intellectual property protection?
- What are some current ethical issues that arise under intellectual property law?

Imagine you are part of the team launching a new smartphone that becomes an overnight sensation. The device combines powerful hardware, polished software, and a rich ecosystem of apps, and customers are willing to pay a premium because nothing else on the market feels quite like it. Analysts estimate that the physical components in each phone cost far less than the price consumers pay, which means much of the product's value comes from what cannot be seen on a parts list: the design, the user interface, the software platform, the brand, and the ecosystem that connects it all together.

Now imagine you are a competitor watching this success from the sidelines. In theory, you could buy the device, take it apart, and study exactly which chips, sensors, and screens it uses, a process known as reverse engineering. You could even hire engineers to build something that looks very similar and sells for less, hoping to ride on the original product's reputation. In practice, this strategy quickly runs into a major obstacle: intellectual property law.



Figure 8.1.1: "DSC_1979: a woman taking a picture with her cell phone" by PattayaPatrol is licensed under CC BY-SA 2.0.

Intellectual property (IP) refers to creations of the mind—such as inventions, software, brands, designs, and artistic works—that the law protects through rights like patents, trade secrets, trademarks, and copyright. These rights do not protect the physical parts of a product as much as they protect the ideas, expressions, and distinctive features that make the product unique. By giving creators exclusive control over how their creations are used for a limited time, IP law makes it illegal for competitors to simply copy successful products, even if they can figure out how they are made.

This protection is more than just a legal technicality; it is a core economic incentive. Businesses in technology, media, pharmaceuticals, and many other industries invest heavily in research, design, software development, and branding because they know they can recover those investments and potentially profit from them if their IP is protected. Without IP rights, rivals could free-ride on that investment by cloning products and content, which would weaken the motivation to innovate, create, and take risks in the first place.

Your Ideas Are the Real Target

Think about a tech company that builds a cool new app or AI tool. The most valuable thing they own is not the laptops on the desks or the servers in the lab. The real value is in what they created in their minds: the source code, the special algorithms, the training data, and the design of how everything works together.

These things are called **intellectual** property. They are not physical objects you can hold, but they can be worth millions of dollars. A lot of this information is protected as trade secrets (kept private inside the company) and as copyrighted works (like the written source code itself).

Now imagine this company is hit by a cyberattack. Hackers break into the company's internal systems and copy parts of the app's source code and design documents. Source code is basically the "recipe" that tells the computer exactly what to do, step by step. If attackers steal that recipe, they can study it, look for weaknesses, or even reuse parts of it in their own products or malware.

This is not just a security problem. It is also an intellectual property problem. The stolen code was a trade secret and a copyrighted work. When it leaks, the company may lose its competitive advantage and may have a harder time arguing in court that the information is still a "secret" worth special protection. In recent years, governments and courts have treated this kind of cyberattack as both hacking and trade secret theft, sometimes even imposing sanctions or criminal penalties.

Why Cybersecurity Protects Intellectual Property

For many companies today, a "data breach" is really an "IP breach." Attackers are not only after passwords or credit cards. They also want product designs, formulas, unreleased features, and AI models that give one company an edge over others. Ransomware groups and state-backed hackers know they can make money by stealing and threatening to leak these secrets.

Because of this, cybersecurity and IP protection now go hand in hand. Companies use strong passwords, multi-factor authentication, access controls, and secure development tools not just to be safe, but also to show they are taking "reasonable steps" to keep their trade secrets secret. If they do not protect their systems, they risk losing both their data and their legal rights in court.

How This Connects Back to IP Law

Intellectual property law gives companies legal tools to fight back when their ideas are stolen, including through cyberattacks. Trade secret laws, copyright laws, and sometimes patent laws can all apply to stolen software and designs. In this chapter, we will explore how IP has been embedded in the legal and economic framework of the United States from its earliest days. We will examine the four major categories of IP, patents, trade secrets, trademarks, and copyright, what each one protects, how they are obtained, how long they last, and how they work together in modern businesses. By the end, you should be able to explain why IP rights matter in a knowledge-based economy, recognize the challenges of doing business in countries that do not strongly protect IP, and identify the real-world impact of IP infringement, from counterfeit goods to unauthorized downloading and streaming of digital content and AI.

Key Takeaways

- Companies invest significant resources in developing new products, services, and brands whose value often far exceeds the cost of their physical components.
- Reverse engineering makes it relatively easy for competitors to understand how many products are built, but IP law limits how far they can go in copying those products or the ideas behind them.
- Intellectual property rights—especially patents, trade secrets, trademarks, and copyright—create legal protection and economic incentives that encourage individuals and firms to innovate, create, and bring new ideas to market.

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8.2: Patents

Learning Objectives

- Understand what a patent is, as well as the different types of patents that exist.
- Learn the criteria required for an item to be patentable.
- Explore controversial issues surrounding patents.
- Examine patent infringement and its consequences.
- Understand boundaries and limitations on patent rights.

Imagine that you invented the Apple iPhone 18. If you invent a patentable item that is useful, new, and nonobvious, and if you are capable of describing it in clear and definite terms, you may wish to protect your invention by obtaining a patent. A patent grants property rights to the inventor for a specified period of time, with a utility patent and a plant patent expiring twenty years following the original patent application and a design patent expiring fourteen years afterward. A patentee owns a patent.

However, if you invented the Apple iPhone 18 while employed to perform creative and inventive work, then any patents obtained with respect to your work would be assigned to your employer. Many inventors and designers work for employers in creative and inventive capacities. This arrangement allows innovative ideas to be adequately funded in trade for the property rights resulting from patents granted to those inventions.

Three patent types exist. Utility patents may be granted for machines, processes, articles of manufacture, compositions of matter, or improvements to any of those items. The Apple iPhone 18 certainly is the subject of utility patents. A design patent may be granted for ornamental designs for an article of manufacture. A plant patent covers inventions or discoveries of asexually reproduced plants (e.g., plants produced through methods such as grafting).

Not all items are patentable. For instance, an idea alone (without a definite description) cannot be patented. So even if you dreamed up the idea of something that looked and functioned exactly like the Apple iPhone 18, you would not have been eligible for a patent on your idea alone. Likewise, physical phenomena, the laws of nature, abstract ideas, and artistic works cannot be patented. Note, however, that artistic works can be copyright-protected. Additionally, otherwise patentable subjects that are not useful, or items that are offensive to public morality, are not patentable.

So what does it mean to have a patent? Just like real property ownership, a patent confers the right to exclude others. If you owned a parcel of real property, your ownership interest would allow you to exclude others from your land. The rule of law would protect your right to exclude against the intrusions of others, which is the very essence of ownership. Likewise, a patent confers the legal right to exclude others from making, using, or selling the patented product. This is consistent with the Copyright Clause of the U.S. Constitution, which grants inventors the “exclusive Right to their...Discoveries.” For others to legally make, use, or sell the patented product, they would have to be granted permission by the patentee. This is often accomplished through a licensing agreement, in which the patentee authorizes others to sell, make, or use the product.

For instance, some genetically modified agricultural products are the subjects of utility patents. Monsanto Company patented *Genuity Bollgard II Cotton*, designed to resist worm damage, which can be a devastating problem for cotton farmers. This product reduces the need for farmers to spray insecticides. Patentees, such as Monsanto Company, hold many patents on agricultural products such as cotton, soybeans, canola, and corn. In the United States, these patents typically protect new plant breeds as well as parts of the plants. In contrast, some countries, such as Canada, do not permit the patenting of life forms. In countries where the patenting of whole life forms is prohibited, the patents typically protect the genetically modified parts of the life form, such as the genes and the cells, as well as the process for inserting the genes into the cells.

Do genetically modified plants meet the threshold requirements to be the subject of a patent? Remember that to be a patentable item, the invention must be useful, new, and nonobvious. Genetically modified plants are useful because they possess some particular quality for which they were designed. For example, *Genuity Bollgard II Cotton* resists many types of damaging worms while reducing the need for farmers to use insecticides, and so this invention can be said to be useful. Likewise, some patented genetically modified agricultural products are resistant to herbicides, such as Monsanto Company’s *Roundup Ready* line of agricultural products. *Roundup Ready* products are resistant to an herbicide known as glyphosate, which is the main active ingredient in the herbicide line marketed by the Monsanto Company under the *Roundup* brand. These are also useful inventions,

because farmers who plant those patented herbicide-resistant products do not have to wait to plant their crops until their fields are cleared of weeds. They can plant their crops before they spray herbicides because the genetically modified crops will resist the herbicide and continue to grow. This allows the farmers to put their land to use for longer periods of time and with more confidence that they can kill weeds without damaging their crops. They can do so using inexpensive methods, such as by spraying herbicides, rather than hand-weeding, which is very labor-intensive.

Genetically modified plants are new and entitled to be patented when no one else has applied for a patent for that particular invention. If, for example, some other company had invented the same product that eventually became known as *Genuity Bollgard II Cotton* before the Monsanto Company had invented that product, then the Monsanto Company would not have been permitted to patent that product, even if it had independently invented that product with no knowledge of the other invention. In this way, we can see that patents are granted in the United States by the “first to invent” rule. Many other countries follow the “first to file” rule, which means that the first applicant to file for a patent on a particular invention is eligible for the patent, regardless of who first invented it. There are legal movements to amend the U.S. Patent Act to change from “first to invent” to “first to file,” but no amendment has yet been passed.

Genetically modified plants are non-obvious inventions if they are different from what has been used before, so that someone with ordinary skill in genetically modified plant technology would not find the new invention to be obvious. For example, if the “new” invention only changed the color of one tiny cell in the entire plant, that would probably not be a patentable invention.

You might be wondering how a patent can be granted over a living thing, like a plant. As mentioned earlier in this section, in the United States, living things are patentable. Living things became the legal subjects of patents when, in 1980, the U.S. Supreme Court held that a bacterium designed by its inventor to break down crude oil components was the legitimate object of a patent (*Diamond v. Chakrabarty*, 447 U.S. 303 (1980)). Indeed, as the Supreme Court noted in that case, congressional intent regarding the U.S. Patent Act was that “anything under the sun that is made by man” is patentable. Since then, we have seen many living organisms patented. For example, the OncoMouse was among the first patented mammals. The OncoMouse is useful in medical research for its extreme propensity to develop cancer.

The patentability of life forms is a contentious issue. While the usefulness of such inventions is proven (or else they would not be patentable inventions), ethical questions abound. For example, when considering the OncoMouse, legitimate questions include whether intentionally creating life to experience pain, sickness, and medical procedures is ethical. Moreover, many people find the idea of “creating” life in a laboratory morally repugnant, as well as owning the products of that creation. Many fear a slippery slope: Today a mouse; tomorrow, a human? Of course, humans are not patentable subjects today, but the slippery slope argument often arises in such discussions. With respect to genetically modified agricultural products, many people question the wisdom of placing control and ownership over items essential to life—like staple crop seeds—into the hands of a few, especially when money must be traded for the rights to use those products. This issue is particularly complicated given the fact that genetically modified agricultural products may cross-pollinate with non-genetically modified agricultural products, resulting in progeny that contains the genes or cells that are patented. When this happens, courts routinely recognize that the patentee has the rights to those progeny by virtue of their patent ownership and that the unwitting possessor of those progeny has, in fact, committed patent infringement by being in possession of those patented products without permission.

Another controversial issue surrounds the patents granted to pharmaceutical drugs. Large drug companies rely on patent law to protect their massive investment in research and development into new drugs, the vast majority of which never make it to market. For the few drugs that eventually find government approval and commercial success, manufacturers seek to extract the highest possible price during the period of patent monopoly. For example, the introduction of antiretroviral drugs has greatly extended the lives of HIV/AIDS patients, but the drugs cost between \$10,000 and \$12,000 per year in the United States. In many developing countries in Asia and Africa, the drugs would make a dramatic impact on human life. Some governments have therefore declared national health emergencies, a procedure under international treaties that permits those governments to force drug companies to license the formula to generic drugmakers (this is called compulsory licensing). Cipla, a generic drug manufacturer in India, manufactures the same antiretrovirals for about \$350 a year, or less than one dollar a day.

The U.S. Patent and Trademark Office (USPTO) grants property rights to patentees within the United States, its territories, and possessions. Patent law is complicated, and attorneys who wish to prosecute patents (file and interact with the USPTO) must have an engineering or science background and pass a separate patent bar exam. When an application is filed, the USPTO assigns a patent examiner to decide whether the patent application should be approved. While the application is pending, the applicant is

permitted to use the term “patent pending” in marketing the product to warn others that a patent claim has been filed. Even after a patent has been issued by the USPTO, however, the patent is merely “presumed” to be valid. If someone challenges a patent in a lawsuit, final validity rests with the U.S. federal courts. For decades, the U.S. Supreme Court routinely ignored patent appeals, allowing lower courts to develop patent law. In recent years, under Chief Justice John Roberts, the Supreme Court has dramatically increased its acceptance of patent disputes, perhaps as a sign that the Court believes too many patents have been issued.

In the last decade, there has been an over 400 percent increase in the number of patents filed, resulting in a multiyear delay in processing applications. An increase in the number of business method patents contributed to this dramatic increase in patent applications. A business method patent seeks to monopolize a new way of conducting a business process. Figure 8.2.1, for example, describes a method of e-commerce by which a customer can order an item and pay for it immediately with just one click of a mouse button. This one-click patent was granted to Amazon.com, much to the chagrin of other online retailers such as Barnes & Noble, who were prohibited from using a similar checkout mechanism. Amazon licensed the patent to Apple so that it could feature one-click on its website.

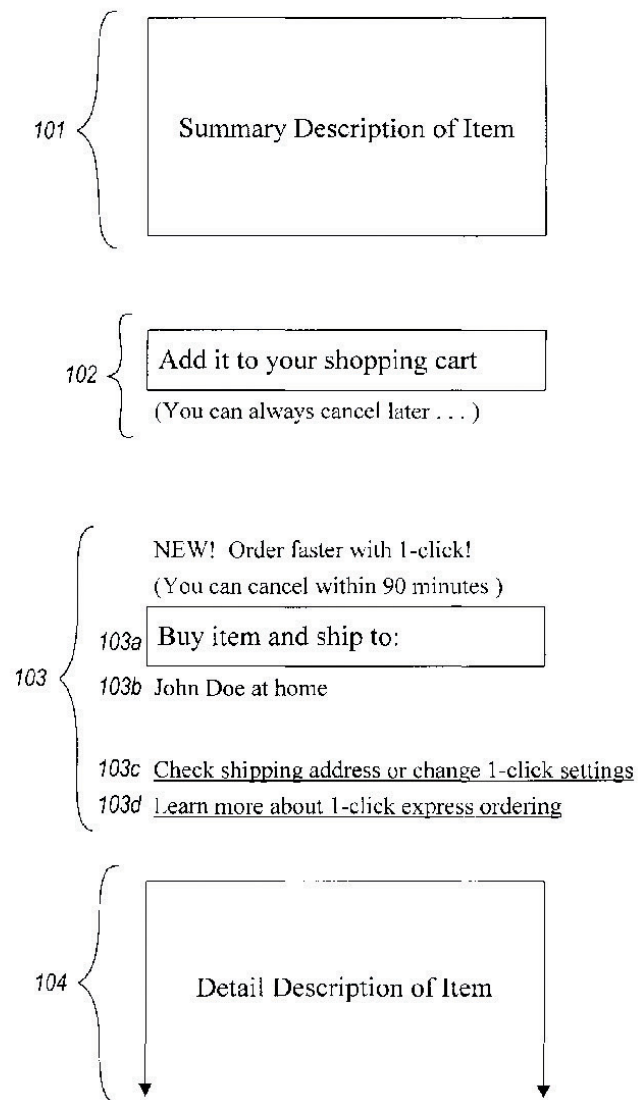


Fig. 1A

Figure 8.2.1: Patent Filing for One-Click Web Ordering. Source: Courtesy of [Free Software Magazine](#).

Outside the United States, a patent granted by the USPTO does not protect the inventor's interest in that property. Other steps must be taken by the inventor to protect those rights internationally. If someone possesses the patented object without permission from the patentee, then the possessor can be said to have infringed on the patent owner's rights. Patent infringement is an actionable

claim. A successful action may result in an injunction, treble damages, costs, and attorneys' fees. One defense to a patent infringement claim is to challenge the validity of the patent.

Learn More: Walmart Tries to Produce Shoes

Nike sued Walmart stores for selling a shoe that Nike claims infringes on its patents. The shoe sold by Walmart uses technology similar to Nike's Shox technology. Look at [Nike's complaint](#).

Do you think that Nike has a good claim? What should Walmart's defense be?

In recent years, several companies that do nothing but sue other companies for patent infringement have emerged. These patent-holding companies, sometimes called patent trolls by critics, specialize in purchasing patents from companies that are no longer interested in owning them and then finding potential infringers. One such company, NTP, sued Research in Motion (RIM), the maker of the BlackBerry device, for a key technology used to deliver the BlackBerry's push e-mail feature. Faced with a potential shutdown of the service, RIM decided to settle the case for more than six hundred million dollars.

Exercise 8.2.1

1. Do you think that life forms should be the subjects of patents? Does your answer change depending on whether we are talking about bacteria, plants, animals, or humans? What are the most persuasive arguments in favor of, and against, allowing the patentability of higher life forms?
2. How do patent rights encourage innovation?
3. If patents are protected monopolies, why do you think patent applications are a matter of public record?
4. Do you agree with compulsory licensing of life-saving medications in response to national health emergencies? What are the consequences of compulsory licensing to the patentee? To the people in need of these medications in wealthy countries? To the people in need of these medications in poor countries?

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8.3: Trade Secrets

Learning Objectives

- Understand what a trade secret is.
- Learn the differences between trade secret and patent protection.
- Learn how trade secrets may be lawfully discovered.
- Explore the concept of misappropriation and the legal consequences.

Imagine that you are in an antique store and find a nineteenth-century ledger book for sale, originally from the W. B. Morrison & Co. Old Corner Drug Store in Waco, Texas. Among the recipes for hair restorers and cough syrups, something in particular catches your eye—a recipe entitled *D Peppers Pepsin Bitters*. What if you also knew that Dr. Pepper was first created and served in that very drugstore? What if you offered to pay two hundred dollars for the old ledger book, even though if it did contain the recipe for Dr. Pepper, it would be worth far more? After all, according to the company that manufactures Dr. Pepper, only three people know the recipe to that very closely guarded trade secret. Something very similar to this happened to Bill Waters. He found the ledger book in an antique store, and he paid two hundred dollars for it. However, at the time, he did not know that the book might date back to the exact time and place from which the popular soda was created. In fact, he did not even notice the recipe until later, and it took him several more days to recognize the possibility that it might be an early version of Dr. Pepper.



Figure 8.3.1: Dr. Pepper Bottle. Source: [Wikipedia \[en.Wikipedia.org\]](https://en.wikipedia.org).

Unlike patents, a trade secret can last forever. That is, it can last forever if the owner of the secret can, well, keep it a secret. If someone uses lawful means to uncover the secret, then the secret is no longer protected by the secret's owners. Does this include reverse engineering? Yes. Reverse engineering is an absolutely legal means of discovering a trade secret. What about ferreting out secrets from an employer's safekeeping, while employed and under a binding confidentiality agreement? No. That is an actionable claim for misappropriation, and the secret's owners can pursue damages.

Trade secrets are unlike patents in another important way. With a patent, the inventor must specifically disclose the details of the invention when applying for a patent. This means that the inventor has not protected the secret of the invention. However, in exchange for this disclosure, a patent owner has a legal monopoly over the property for a specified period of time. So even if others discover the secret of the invention (not a difficult task since patent applications are public record), they are prohibited from making, using, or selling it without the patentee's permission. After the patent expires, then the patentee no longer has a property right to exclude others.

So what is a trade secret? It is, in short, secret information. This information may include a process, formula, pattern, program, device, method, technique, or compilation. For many companies, lists of suppliers, costs, margins, and customers are all trade secrets. Soft drink recipes, KFC's eleven spices, the donut mix sent to Krispy Kreme franchisees, the Big Mac's special sauce, and even the combination of wood that is used in the burning process to make Budweiser beer are all trade secrets. Additionally, the information derives actual or potential economic value from being a secret that is not readily discoverable by others, and the

information is the subject of efforts to keep it a secret. While most states have adopted the Uniform Trade Secrets Act (UTSA), not all have, so the definition of trade secret can vary by jurisdiction. Unlike patents, trademarks, and copyrights, there is no federal law protecting trade secrets.

A claim for misappropriation may be brought when a trade secret has been wrongfully obtained, such as through corporate espionage or bribery. Generally, according to the UTSA, misappropriation occurs if the secret was acquired by improper means, or if the secret was disclosed or used without permission from the secret's owner. Damages may include actual loss and unjust enrichment not captured by actual loss. Additionally, in cases of willful or malicious misappropriation, double damages may be awarded, as well as attorney's fees.

So what if you are never lucky enough to discover a multimillion-dollar secret recipe hidden away in an antique shop? As long as the recipe is not patented, you can try to reverse engineer it. If you succeed, you can use it immediately. However, if you are working for an employer in a creative capacity, working with others to develop the secret, and if you have agreed not to use trade secrets, then the right to the trade secret will belong to your employer, at least in most jurisdictions. Ask Peter Taborsky, an undergraduate student at South Florida University in 1988. According to Taborsky, while working in the university's chemical engineering lab, he began conducting experiments on his own. He discovered a highly effective method for treating sewage. The university demanded that he hand over his notebooks that contained the secrets of this invention. Taborsky refused and filed for a patent for his invention, which he received. However, the university pressed criminal charges for stealing trade secrets. Taborsky lost his case and found himself in a maximum-security facility working on a chain gang.

So does Bill Waters need to worry about Dr. Pepper's owners suing him for misappropriation or pressing criminal charges for stealing trade secrets? No. He lawfully obtained the ledger book by purchasing it in the open market. Additionally, according to a company spokesman, the ingredient list under *D Peppers Pepsin Bitters* is most likely an old remedy for a stomachache rather than any version of the recipe for Dr. Pepper. Even if Mr. Waters had accidentally stumbled on the exact Dr. Pepper recipe, he would have a good argument that the company did not take steps to keep the secret a secret. If it had, he could argue, the company never would have allowed the recipe out of its sight.

Key Takeaways

Trade secrets last forever if the owner of the secret keeps the secret. However, if someone else discovers the secret through a lawful method, then the owner of the secret has no right to exclude others from using the secret. Unlawfully obtaining a trade secret is called misappropriation, which is an actionable claim. The Uniform Trade Secret Act has been adopted by most (but not all) states, so different jurisdictions have different rules of law concerning trade secrets.

? Exercise 8.3.1

1. If you owned a trade secret, what methods would you employ to protect it?
2. If you invented something that was patentable or the subject of a trade secret, what types of issues would you consider when deciding whether or not to apply for a patent?

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8.4: Trademarks

Learning Objectives

- Understand what a trademark is.
- Learn what can and cannot be trademarked.
- Explore how companies protect trademarks from dilution and genericide.
- Examine how the Internet poses new challenges to trademark owners.
- Explore the tension between trademark protection and free speech.

Look at Figure 8.4.1 "McDonald's, One of the Most Recognized Trademarks in the World". It's obviously a McDonald's restaurant, but can you tell where this restaurant is? Is it in a mall or an airport? Is it in Trenton, Toronto, or Tokyo (or, as it turns out, Messestadt Riem in Germany)? Without additional information, it may be impossible to tell. And yet, no matter where you are in the world, if you enter this McDonald's restaurant, there are certain standards that you expect. You would expect to find a Big Mac on the menu, perhaps Chicken McNuggets and french fries too. You would expect those menu items to taste the same as they do in your local McDonald's. Perhaps you'd expect a certain level of service from the employees, a certain value proposition for your money, a certain look from the uniform and fixtures, or perhaps a clean restroom. If you walked into this McDonald's restaurant and found out that it was in fact not McDonald's, you might be confused. The ultimate goal of trademark law is to prevent this consumer confusion. To prevent any other restaurant from using the name McDonald's, or from using a logo that looks like a stylized "M," McDonald's can trademark both its name and logo (and a lot of other elements of its brand as well). In this section, we'll examine how trademark law accomplishes this goal.



Figure 8.4.1: McDonald's, One of the Most Recognized Trademarks in the World. Source: commons.wikimedia.org/wiki/File:RiemArcaden.McD.JPG.

A trademark is any kind of name, logo, motto, device, sound, color, or look that identifies the origin of a particular good or service. Something begins to look like a trademark when a consumer *identifies* it with a particular origin. For example, someone buying a Diet Coke knows that he or she is getting a carbonated beverage from the Coca-Cola Company. If he or she bought a Diet Cola, on the other hand, there's no association in the mind with any particular company, so it could be from Coca-Cola, Pepsi, or any number of other companies. The key is consumer identification with a specific origin. If a consumer thinks of a class of goods rather than one specific origin, then it's not a trademark. So, for example, when a consumer hears "aspirin," he or she thinks of a class of goods with no particular origin because aspirin is not a trademark. But if a consumer hears "Bayer," he or she thinks of a specific aspirin from a specific source, making "Bayer" a trademark.

Learn More: Trademarking Sounds

Can sounds be trademarked? Yes! Some sounds are instantly recognizable, such as Twentieth Century Fox's movie opening scene. [Explore other trademarked sounds.](#)

A federal law, the Lanham Act, protects trademarks. Unlike copyrights and patents, trademarks can last forever and are not subject to the Constitution's "limited time" restriction. Since the objective of trademark law is to prevent consumer confusion, the public

good is best served by allowing companies to maintain their trademarks as long as consumers associate a trademark with a specific origin. The moment they no longer make that association, however, the trademark ceases to exist.

If you are considering marketing as a career, you will become intimately familiar with the concepts related to branding and the value of branding. At its core, marketing involves the science of relating to consumers, telling them an authentic story about your product and service, and satisfying their wants and needs. Having a brand is essential to carrying out this objective, and it can lead to startling profits. The Apple and iPhone brands, for example, are very strong and yield billions of dollars in profits for Apple. Luxury brands are particularly aware of this phenomenon, as often their brand alone can justify pricing far above a similar good. Gucci, such as this store in Hong Kong (Figure 8.4.2 "Gucci Store in Hong Kong"), trades on the value of its brand to command premium prices (and margins) in the marketplace. Brands such as Rolex, Hermes, Rolls-Royce, and Bentley have similar business models. These brands are all trademarks—indeed, all brands are either registered trademarks or are trademarkable because they share the common feature of consumer identification. Be careful, though. “Trademark” and “brand” are not interchangeable terms because not all trademarks are brands.



Figure 8.4.2: Gucci Store in Hong Kong. Trademark law is especially important for luxury brands such as Gucci. Source: Photo courtesy of Maizeam, [Wikimedia](#).

So, what can be a trademark? Obviously, words can be trademarked. When it comes to trademarks, distinctiveness is good. Therefore, an invented word is the best type of trademark. In 1997, for example, when Stanford grad students Larry Page and Sergey Brin were brainstorming names for their new Internet search engine, they settled on the word “Google,” a play on “googol,” which means 1 followed by 100 zeroes. They felt the name reflected their goal to organize the staggering amount of information available on the Internet. On the other hand, regular words can also become trademarks, as long as consumers identify them with a particular source. Amazon, for example, is the name of the world’s longest river, but it’s also the name of an online retailer. Since consumers now identify Amazon.com as an online retailer, the name can be trademarked. Another example is the phrase “You’re Fired” when used in a television program. The phrase was made popular by President Donald Trump (Pre-Presidency on *The Apprentice*) and has such lasting recognition now that it’s unlikely any other television show could use that phrase as a central part of its theme.

Consider what would happen if you tried to trademark your name. If your name happens to be Sam Smith, you’d probably have a pretty hard time getting a trademark for your name. If, however, you called your business Sam Smith anyway and started growing your business so that eventually, over time, consumers began to identify “Sam Smith” as your business, then your name has acquired a secondary meaning and can be trademarked. Thus, Sam Adams is a trademark for a beer, Ben & Jerry’s is a trademark for ice cream, and Ford is a trademark for a motor vehicle.

Learn More: Trademarking Phrases

Can a sportscaster trademark the phrase “Are you ready to rumble”? Can Paris Hilton trademark the phrase “That’s hot”? As long as the public associates these phrases with a distinctive origin, the answer is yes. Listen to this [National Public Radio broadcast](#) for more examples.

Note that when you get a trademark, it’s typically granted for a specific category of goods. The same name can sometimes be used for multiple categories of goods. The name Delta, for example, is a trademark for both an airline and a brand of faucets. Since there

is little chance that a consumer will be confused by an airline or faucet brand, trademark law allows these dual registrations. On the other hand, some brands are so strong that they would probably stop registration even for a completely different category of goods. McDonald's is a good example of this. The McDonald's trademark is one of the strongest in the world, meaning that it is instantly recognizable. In 1988, for example, hotel chain Quality Inns decided to launch a new line of budget motels called "McSleep." McDonald's sued, claiming trademark infringement. McDonald's claimed that consumers might be confused and believe that McDonald's owned the hotel chain. A federal judge agreed and ordered Quality Inns to change the name of the chain, which it did, to Sleep Inns.

Trademarks go beyond simply a company's name or its logo. A color can be trademarked if it's strong enough to create consumer identification. Pink, for example, is trademarked when used for building insulation by Owens Corning. All other insulation manufacturers must use different colors. Sounds can be trademarked, too, such as MGM Studios' "lion's roar." Even a certain "look" can be trademarked if a consumer identifies it with a certain origin. Thus, the distinctive colors, materials, textures, and signage of a Starbucks or T.G.I. Fridays are considered trade dress and cannot be copied. A bottle shape can be considered trade dress, too, such as the shape of a nail polish bottle (Figure 8.4.3 "OPI's Nail Polish Bottle"). OPI, a nail polish manufacturer, has registered this bottle shape with the U.S. Patent and Trademark Office (USPTO) and is suing other manufacturers that use a similarly designed bottle. Interestingly, courts have been reluctant to grant certain smells trademark protection, even though it can be argued that certain fragrances, such as Old Spice or CK One, are distinctive. Imagine the chaos that would ensue if one company claimed trademark protection for vanilla or strawberry scents—consumers would ultimately be robbed of choice if that were to happen.

A trademark is not limited to a name or logo used to sell goods. If a company provides a service (as opposed to selling goods), it too can receive trademark protection. In this case, it's called a service mark. Facebook, for example, is a service mark. A trademark can also be used to demonstrate certification meeting certain standards, such as the Good Housekeeping Seal of Approval. If you study operations management, you'll learn about the International Organization for Standardization (ISO) and its various standards for quality management (ISO 9000) or environmental quality (ISO 14000). The Forest Stewardship Council (FSC) allows its logo to be used on paper products that come from sustainable forests, while certain foods can be labeled "Organic" or "Fair Trade" if they meet certain standards as established by governmental or nongovernmental organizations. Each of these marks is an example of a certification mark. Finally, a mark can represent membership in an organization, such as the National Football League, Girl Scouts of America, Chartered Financial Analyst, or Realtor (Figure 8.4.4 "Realtor" Certification Mark"). Each of these is known as a collective mark. The rules that apply to trademarks apply equally to service marks, collective marks, and certification marks.



Figure 8.4.3: OPI's Nail Polish Bottle. A bottle's shape can be trademarked if it is distinctive enough. Source: Photo courtesy Jessica Ta, [Flickr Image \[www.flickr.com\]](https://www.flickr.com/photos/jessica_t/1111111111/).

If a color or sound can be trademarked, is there anything that cannot be trademarked? The Lanham Act excludes a few categories from trademark registration, mainly for public policy purposes. Obviously, trademarks will not be granted if they are similar or identical to a trademark already granted. If you're starting a new company, it's a good idea to make sure that not only is a domain name available for your company's name, but that the name isn't already trademarked by someone else. Trademarks also cannot contain the U.S. flag, any government symbol (such as the White House or Capitol buildings), or anything immoral. Trademarks cannot be merely descriptive. (Thus, every restaurant is allowed to offer a "Kid's Meal," but only McDonald's can offer a "Happy Meal.")



Figure 8.4.4: “Realtor” Certification Mark. Source: upload.wikimedia.org/Wikipedia/en/1/16/Realtor_logo.jpg.

Whether or not a region can be trademarked (a geographic indicator, or GI) is the subject of some controversy, especially with our trading partners. “Maine Lobster,” “Napa Valley Wine,” or “Florida Orange Juice,” for example, may indicate to some consumers the origin of a particular lobster or bottle of wine or orange juice, and thus may be of commercial value to distinguish the product from competitors from other regions. For the time being, these foods must come from Maine, California, or Florida to avoid liability under consumer protection statutes for fraud (lying) about their origin. What happens, though, if consumers lose the association with the region? For years, sparkling wine manufacturers in Champagne, France, have fought to prevent this from happening by requiring that only sparkling wine made in the Champagne region be called “champagne.” Now, food producers (especially in the European Union) are seeking similar protection under international trademark law for Feta, Parmesan, Gorgonzola, Asiago, and hundreds of other names.

A trademark is valid as long as consumers believe that the mark is associated with a specific producer or origin. If the mark refers to a class of goods instead, then the trademark can no longer exist. This process is called genericide. Many words today once started as trademarks: furnace, aspirin, escalator, thermos, asphalt, zipper, softsoap, cellophane, lite beer, Q-tip, and yo-yo are all examples of trademarks that are now generic and have therefore lost legal protection. To prevent genericide from occurring, trademark owners must take active steps, often costing millions of dollars, to educate consumers on the importance of using their trademarks properly and to prosecute infringers. For example, when you hear the word “Kleenex,” do you think of a brand of tissue owned by Kimberly-Clark, or do you think of tissues generally? Does “Rollerblade” refer to a brand of in-line skates, or to all in-line skates? In Southern states, does “Coke” refer to a Coca-Cola, or to soft drinks generally? When you run a “Xerox” photocopy, is it on a Xerox photocopier or some other machine? These trademarks, all currently active and worth billions of dollars to their owners, are in danger of becoming generic in the United States. If that happens, the companies will lose control of the marks and the public (and competitors) will be free to use those words just as they use “aspirin” and “yo-yo” today. Xerox has taken many steps to educate the public about its trademark, including running print advertisements in business periodicals. In one of these ads, the text says, “When you use ‘Xerox’ the way you use ‘aspirin,’ we get a headache.”

Trademark infringement occurs when someone uses someone else’s mark, either completely or to a substantial degree, when marketing goods or services, without the permission of the mark’s owner. Obviously, making your own pair of jeans and slapping a “Levi’s” label on it, or making your own handbag and sewing a “Coach” label on it, constitutes trademark infringement. When Apple first released the iPhone, to its embarrassment, it found out that “iPhone” was already a registered trademark belonging to Cisco, another company, for a phone used for placing phone calls over the Internet. To avoid trademark infringement liability, Apple had to pay Cisco an undisclosed sum to purchase the trademark. Ford found itself in a similar situation when it released a supercar called the “Ford GT.” Ford made a similar racing car in the 1960s called the “GT 40” but lost control of the trademark after production ceased. Unable to reach an agreement with the current trademark owners, Ford settled for releasing the new car as simply the “GT.”

The law also permits trademark owners to sue infringers who use their marks to a substantial degree. For example, when Samsung announced its new smartphone, the Black Jack, the makers of the BlackBerry device sued for trademark infringement. When a software company released a product to eliminate unwanted e-mails called “Spam Arrest,” it was sued by Hormel, makers of Spam

canned luncheon meat. When a small coffee shop in Syracuse, New York, opened as “Federal Espresso,” the shipping company FedEx filed a trademark infringement claim.

Even if a trademark owner doesn’t believe a similar use of its mark would lead to any consumer confusion, it can protect its trademark through a concept called dilution. Such was the case when an adult novelty store in Kentucky opened as “Victor’s Secret” (the owner’s name was Victor). The trademark owners of “Victoria’s Secret” filed a dilution suit in response. Traditionally, trademarks are intended to prevent consumer confusion. Dilution permits a trademark owner to stop usage of a similar word or phrase even if consumers aren’t confused. Under dilution concepts, the trademark owner only needs to show that its mark will be diluted or tarnished in some way.

Dilution is controversial in trademark law. When Congress passed the first dilution law in 1995, the Federal Trademark Dilution Act, many felt that Congress had gone too far in protecting trademarks, to the detriment of the public and small businesses. For one thing, the Act only protected “famous” trademarks. It also failed to clearly define “dilution” and what was required for trademark owners to win a lawsuit. Finally, when the Victor’s Secret case reached the Supreme Court, *Moseley v. Victoria’s Secret Catalogue*, 537 U.S. 418 (2003)[0].[0] the Supreme Court issued some clarification. The Court ruled that to win a dilution case, a trademark owner had to show that it had suffered actual economic damage from the dilution, not merely the “likelihood” of dilution. This is a high standard for trademark owners to meet because it means that they (1) have to wait for the diluting mark to hit the market and be used in commerce and (2) must be able to prove that they suffered economic damage from the diluting mark. Unhappy with the Court’s decision, corporations lobbied Congress to pass the Trademark Revision Dilution Act of 2006, which overturns the Moseley case. Now, trademark owners of famous trademarks only need to show a likelihood of dilution before filing a dilution lawsuit.

Companies or persons accused of trademark infringement have several defenses to rely on. The most obvious is arguing that no infringement has occurred because the two marks are sufficiently different that consumers won’t be misled. For example, in 2002, Jeep sued General Motors for infringing on what Jeep called its trademark grill. GM’s Hummer division released the H2 that year, with a similar seven-bar grill. A district court held that there was no trademark infringement because the grills were too dissimilar to cause consumer confusion. Look at the Hummer H2 grill (Figure 8.4.5 “Hummer H2 Grill”) and the Jeep grill (Figure 8.4.6 “Jeep Grill”). Do you think there is a chance of consumer confusion?



Figure 8.4.5: Hummer H2 Grill. Source: Photo courtesy of Ramchandran Maharajapuram, [Flickr](#).



Figure 8.4.6: Jeep Grill. Source: Photo courtesy of 3obryans, www.flickr.com/photos/3obryans/1017233.

Another defense is fair use. The Lanham Act prohibits the use of someone else’s trademark when selling goods. It’s not uncommon to see various items, such as laptop computers, telephones, soda cans, or other foods with their labels covered by stickers or blurred out on television shows and movies because of the trademark law. On the other hand, what if a company wanted to mention a competitor’s product to draw a comparison with its own product? This is called comparative advertising, and it’s considered fair use. Honda, therefore, is free to claim that its “Honda Accord is better than the Ford Taurus” in its advertising even though Ford and Taurus are both trademarks owned by Ford Motor Company.

The First Amendment also recognizes the use of parody, comedy, or satire as fair use. Comedy skits on television that make fun of or use company logos are an example of this fair use. Canadian nonprofit Adbusters, for example, claims to be an organization seeking to advance “a new social activist movement in the information age.” Part of its work involves making fun of corporations and consumer spending, sponsoring “Buy Nothing Day” as an antidote to the annual holiday spending season. Making fun of corporations also involves spoofing their commercial messages, as the ad in Figure 8.4.7 “A Parody of the Well-Known Absolut Vodka Print Ads” illustrates. Although the ad undoubtedly infringes on a trademark, it is considered fair use because of the social commentary and satire behind its message.

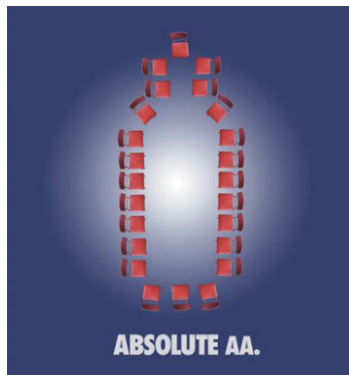


Figure 8.4.7: A Parody of the Well-Known Absolut Vodka Print Ads. Source: Photo courtesy of Adbusters, www.adbusters.org/gallery/spoofads/alcohol/absolutaa.

An interesting aspect of trademark infringement arises through the use of domain names on the Internet. The practice of cybersquatting (or domain name squatting) arises when a company registers a domain name containing a famous trademark in hopes of selling that trademark to its rightful owner for a large profit. The practice arose in the early days of the Internet, when domain name registration took place on a first-come, first-served basis. There is nothing wrong with registering a domain name for a generic word such as “shoes.com,” but incorporating a registered trademark into the domain name, for purposes of selling it later, is considered cybersquatting. This practice was made illegal in 1999 with the passage of the Anticybersquatting Consumer Protection Act. It is only illegal, however, if the domain name is registered to make a profit through a later sale. It is not illegal if someone registers the domain name in “good faith.” A good example is the domain name registered by Canadian teenager Mike Rowe in 2003. An avid computer user, he registered “mikerowesoft.com” as a domain name. Software giant Microsoft launched legal proceedings against him, claiming violation of the cybersquatting statute and trademark infringement. Rowe’s defense was that the website merely reflected his name and his interest in computer programming and software, and was being used for that purpose. After heavy negative publicity, Rowe and Microsoft settled the case, with Microsoft taking control of the domain. Another example surrounds the Nissan.com domain. Uzi Nissan, a computer store owner, had owned the domain for years before Nissan Motors attempted to gain ownership of the domain. Since the domain was registered in good faith, no cybersquatting has occurred. The First Amendment is also a defense to cybersquatting. Websites run by consumer activists who seek to criticize or parody companies, such as “fordreallysucks.com” or “fordlemon.com” or “peopleofwalmart.com” are not cybersquatting in spite of their use of trademarks.

Key Takeaways

Trademarks are anything that identifies the unique origin of goods or services. Trademarks are granted under federal law by the U.S. Patent and Trademark Office and can last forever. When a trademark is no longer associated with a specific origin, it becomes generic and loses legal protection. Trademark owners can take legal action against infringement and dilution of their marks. Fair use of trademarks includes comparative advertising and parody. Trademark protection extends to the Internet, where mark owners can prevent bad faith domain name squatting.

? Exercise 8.4.1

1. Go to the [U.S. Patent and Trademark Office](http://www.uspto.gov). Search the trademark database for the phrase “Let’s Roll.” Do you think that companies should be able to trademark phrases? Can you find other examples?
2. “Netbook” is an example of a term the USPTO recently rejected as being generic, even though it was at one point a registered trademark. Can you think of other recent examples of genericized trademarks?
3. Do you think that the rules of cybersquatting should extend beyond Internet domain names to other uses, such as Facebook or Twitter account names? Why or why not?

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8.5: Copyright

Learning Objectives

- Understand what a copyright is.
- Explore the requirements for copyright protection.
- Learn how copyright owners can license their works for use by others.
- Understand copyright infringement and the fair use defense.
- Understand the Digital Millennium Copyright Act.

The final form of intellectual property (IP) protection is copyright. Like patents and trademarks, federal law protects copyright. Whereas trade secrets protect confidential company information, patents protect processes and inventions, and trademarks protect brands and identity, copyright is designed to protect creativity. It is one of the two types of IP specifically mentioned in the Copyright Clause of the U.S. Constitution. Of course, back then, the only works copyrighted would have been songs, art, or works in writing. Today, copyright extends to any form of creative expression, including digital forms.

If asked to write down four numbers from one to fifty in a random sequence, most of us would write four different numbers. The process of picking those numbers requires creativity, so the sequence of the four numbers you write down is copyrighted. Note that the numbers themselves aren't copyrighted, of course. It's just the unique sequence that you choose, the expression of your creativity, that is copyrighted. Since computer software is a compilation of binary code expressed in 1s and 0s, all software is copyrighted. On the other hand, sequential page numbers or listings in a phone directory show no creativity and are therefore not copyrightable. Similarly, if a group of students were given a camera and each was asked to photograph the same subject, each student would come up with a different photograph. Each student would frame the subject differently, and that is an expression of creativity. Finally, consider the notes that you take in class for this course. A group of students could read the same textbook and listen to the same lecture, and come up with different sets of notes. Each work is unique and demonstrates creativity, so each is copyrighted.

A work must be original (not copied) and fixed in a durable medium to be copyrighted. Therefore, if you sing an original song in the shower in the morning and your roommate hears it and records it, the copyright to the song belongs to your roommate, not you. This requirement exists because it would be impossible to prove, without a durable medium, who is the original author of a work. Ideas, by themselves, cannot be copyrighted. If you had an idea for a novel about a boy wizard who goes to a boarding school with his friends and battles evil monsters while growing up, that would not be copyrighted. If you wrote a novel featuring such a storyline, however, you would run the risk of violating the copyrighted Harry Potter works. A similar dispute arose in 2006 after the blockbuster success of Dan Brown's novel, "The Da Vinci Code." Two authors, Michael Baigent and Richard Leigh, claimed the novel infringed on their copyrighted book, "Holy Blood Holy Grail." In their book, the authors theorized that Jesus survived his crucifixion, married Mary Magdalene, and had children. The British judge hearing the case dismissed the claims, holding that the theory was "too general or too low a level of abstraction to be capable of protection by copyright law." [Baigent v. Random House Group](#).

A copyrighted work is automatically copyrighted upon its creation. Unlike patents and trademarks, which must go through an expensive and rigorous application and approval process with the government, authors do not need to send their work to the government for approval. Although it's a good idea to write "Copyright" or place a © symbol on the work, it's not legally required.

Copyright protection lasts for seventy years after the death of the author. If there is more than one author, the copyright expires seventy years after the death of the last surviving author. If a company, such as a publisher, owns a copyrighted work, the copyright expires ninety-five years from the date of publication, or one hundred twenty years from the date of creation, whichever comes first. After copyright expires, the work falls into the public domain. The works of Shakespeare, Bach, and Beethoven, for example, are in the public domain. They may be freely recorded, performed, or modified without permission. If you were to record yourself reciting Shakespeare's "To be or not to be" speech from *Hamlet*, however, that recording is copyrighted even though the underlying work (*Hamlet*) is in the public domain as a new creative expression. Classical music recordings are similarly copyrighted under the same concept.

The owner of a copyright may allow members of the public to view or use a copyrighted work, for free or for a fee. This use is contained in a copyright license, sometimes called an End User License Agreement (EULA) for software. A license is essentially permission from the copyright holder to violate the copyright, within the terms of the license. When you purchase a physical book, CD, or DVD, for example, the copyright license allows you to view the movie, listen to the music, or read the book, in private. The license does not allow you to show the movie in class to a broad audience, or to record the music into your computer and then modify it, or to make photocopies of the book to give away or sell. These rights of reproduction, exhibition, and sale are not part of the license you received and are reserved by the copyright holder. Of course, you may purchase those rights if you wish, but they will probably cost a lot more than the price of the book or disc. Some organizations advocate the creation of a common license that authors can easily refer to if they wish to distribute their work easily. The General Public License (GPL) for software and the Creative Commons (CC) license for text and media are well-known examples. One right that you do have, however, in spite of any language in the license, is the right of first sale. Essentially, this means that as the owner of the physical work, you can do with it as you please, including reselling the original work.

Licenses in the digital arena can be very restrictive if you purchase digital media. Copyright holders may use schemes such as Digital Rights Management (DRM) to limit your ownership rights in digital media. DRM limits the number of copies and devices a digital file can be transferred to, and in some cases even permits the copyright holder to delete the purchased work. Amazon.com recently deleted digital George Orwell books from owners who had purchased the works for their Kindle reading devices (Figure 9.6.1 "Amazon's Kindle E-reader"), without any prior notification. This would have been impossible if the books were in a physical form. Although Amazon.com was within its rights to do so, the public outcry that followed made Amazon.com promise not to engage in such behavior again in the future.

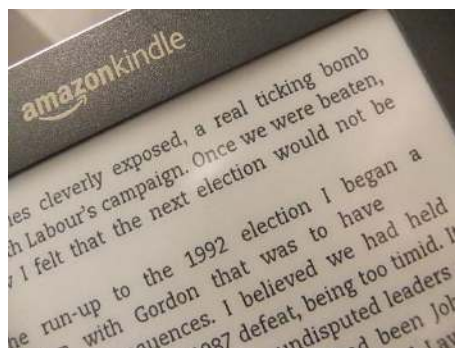


Figure 8.5.1: "Amazon Kindle" by James Cridland is licensed under CC BY 2.0.

Copyright infringement occurs when someone uses a copyrighted work without permission or violates the terms of a copyright license. For example, if a classmate takes your class notes without your permission and makes photocopies of them, the classmate has infringed on your copyright. It's also copyright infringement if you take someone else's work and simply repackage it as your own. This happened to Harry Potter author J. K. Rowling. Her books created a huge fan following, and many fans gather online to discuss the Potter series. One such site is the Harry Potter Lexicon, run by Steve Vander Ark, a former school librarian. The site serves as an encyclopedia to the Harry Potter world, with reference notes on characters, places, spells, and other details. When Vander Ark announced plans to publish the contents of the Lexicon in a book format, J. K. Rowling sued, claiming copyright infringement. The judge agreed and ordered the Lexicon rewritten so that it uses less material from the copyrighted work.

Copyright infringement also occurs when you assist someone in violating a copyright or create a device that assists in violating a copyright. Thus, websites such as the former Napster and Grokster, which existed solely for the purpose of facilitating illegal downloading of music, were held to be infringers even though the websites themselves didn't violate any copyrights. Similarly, if you make digital media available for download for others, you are not engaged in illegal downloading but still liable for contributory copyright infringement. The recording industry, which is battling for its very survival in a new file-sharing world, pursues these cases aggressively. In June 2009, a court in Minnesota ordered Jammie Thomas to pay \$80,000 per song for making twenty-four songs available for download, for a total fine of \$1.92 million. In September 2009, the industry won a \$675,000 verdict against a college student in Massachusetts for file sharing thirty songs. Devices that can be used for purposes other than violating copyrights (such as photocopiers, video/DVD burners, and peer-to-peer networks used for sharing research) are not considered infringing devices.

Copyright law makes a distinction between “fair” use and “infringing” use of a copyrighted work. A fair use includes copying a work for purposes of commentary, criticism, news reporting, teaching, or research. Just because a work is used in a news article or in a classroom, however, does not make its use fair. The law provides four factors that courts must consider in determining whether or not the use is fair. First, the court must consider the purpose and character of the use. Is it for educational purposes, or for making a profit? Second, the court must consider the nature of the copyrighted work. Is the work part of the “core” of the intended protection that copyright provides? Third, the court must consider the amount and substantiality of the portion used. This is an important factor—it’s one thing for your professor to copy an excerpt from a journal or book for distribution in class (probably fair) and another to copy the entire journal or book (probably infringing). Finally, the court must consider the effect of the use on the potential market for the copyrighted work. If the use is considered fair, what would it do to the market for the copyrighted work? For example, if copying an entire textbook is fair, it would probably eliminate the market for new textbooks.

In an attempt to tackle the problem of copyright infringement on the Internet, Congress passed the Digital Millennium Copyright Act (DMCA) in 1998. One portion of the law helps Internet service providers by expressly stating that those providers can’t be sued for copyright infringement if others use their networks for infringing uses. Another portion of the law helps websites by stating that if a website user uploads infringing material and the website complies with a copyright holder’s request to remove the material, the website won’t be liable for infringement. For example, if you upload a portion of a copyrighted song, movie, or television show to YouTube, you may find that YouTube has removed your clip at the request of the copyright holder. Finally, the DMCA makes it illegal to attempt to disable a copy protection device. DVD and Blu-ray Discs, for example, are copy-protected to prevent them from being copied easily. Anyone who writes software (even if the software is distributed for free) that disables this copy protection device is violating the DMCA. In recent years, the DMCA has been used by companies to prevent competitors from making replacement inkjet cartridges, replacement garage door openers, and other replacement parts on the grounds that the replacements circumvent a copy protection device.

AI and Intellectual Property

Artificial intelligence (AI) tools can now write essays, draw pictures, make music, create videos, and even help design new products. Every time an AI creates something, we have to ask two big questions: Who owns it, and what happens to the material the AI learned from? These questions are at the center of today’s debates about intellectual property.

AI systems are trained on huge amounts of data, including books, music, images, code, and other content that may be protected by copyright. Many authors, artists, and companies say their work was used without permission, and they are suing AI companies for copyright infringement and unfair use of their content. Courts in the United States and other countries are now starting to draw lines about when using copyrighted material to train AI is allowed and when it is not.

There is also a second problem: When an AI writes a song or designs a logo, who is the “author” or “inventor”? Right now, the law in the United States says that only human beings can be inventors on patents and authors for copyright; AI itself cannot own rights. This means a person or company must be able to show the human creative work behind an AI-assisted invention or artwork if they want IP protection.

Two major lawsuits help show how copyright law is being tested by generative AI tools. In one case, Dow Jones & Company (publisher of The Wall Street Journal) and the New York Post sued Perplexity AI, arguing that Perplexity copied and used their pay-only news articles to train and run its AI system without permission, which they say violates copyright and ignores the rules on their websites. In another case, Getty Images, a large stock-photo company, sued Stability AI, claiming that Stability used millions of Getty’s photos to train its image-generation tool, Stable Diffusion, without a license, and that the AI can even create pictures that include fake versions of the Getty watermark, which could confuse people into thinking Getty approved or created those images. Together, these cases raise big questions about whether AI companies can freely use online content to train their systems, how far fair use goes, and how much protection businesses have when their copyrighted news stories or images are reused by AI in ways that might replace the original products.



Figure 8.5.2: AI image of a woman reading. Image created by Gemini 2026

AI also changes how companies think about protecting their own IP. The algorithms, model weights, and training data behind a powerful AI system are extremely valuable trade secrets. At the same time, using AI tools inside a company can create new risks, such as accidentally feeding confidential information into public AI systems or generating content that copies someone else's work too closely. Businesses now must combine IP strategy with good cybersecurity and careful AI policies to avoid leaks, lawsuits, and loss of their competitive edge.

As AI keeps improving, intellectual property law will keep evolving too. Governments and courts around the world are issuing new guidance, hearing new cases, and testing how old rules apply to these new technologies. For you as a future professional, this means understanding IP is not just about music downloads and brand names anymore; it is also about how we treat the data, models, and creative content that AI helps us build in the years to come.

Key Takeaways

Copyright protects any creative work fixed in a tangible medium. Copyright protection is automatic without any prior government approval and generally lasts for seventy years after the death of the author. Copyright owners can license others to use their works while retaining full rights of ownership. Digital works are fully protected by copyright and may be encrypted with digital rights management schemes. Copyright infringement, both direct and contributory, is a serious civil violation that can result in heavy monetary penalties. Fair use is a defense to copyright infringement. The Digital Millennium Copyright Act prohibits any attempts to circumvent a copy protection device or scheme.

? Exercise 8.5.1

1. How long do you think copyrights should last?
2. Do you think the use of copyrighted works in parody is fair use? Consider works by Weird Al Yankovic, or Mel Brooks movies, for example.
3. Do you think there is any difference between downloading a song on a peer-to-peer network versus walking into a store, putting a CD into your jacket, and walking out without paying for it? What are those differences? Should the law treat those two acts differently?
4. Is downloading music justifiable because recording artists and companies make a lot of money? Can you think of other industries where this reasoning applies as well?

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CHAPTER OVERVIEW

9: Unfair Trade Practices and Securities Regulations

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9.1: Unfair Trade Practices

The term “unfair trade practice” describes the use of deceptive, fraudulent, or unethical methods to gain a business advantage or to cause injury to a consumer. Unfair trade practices are considered unlawful under the Consumer Protection Act. The purpose of the law is to ensure that consumers have the opportunity to make informed, rational decisions about the goods and services they purchase.

Unfair trade practices include false representation of a good or service, targeting vulnerable populations, false advertising, tied selling, false free prize or gift offers, false or deceptive pricing, and non-compliance with manufacturing standards. Alternative names for unfair trade practices are “deceptive trade practices” or “unfair business practices.”

[Section 5\(a\)](#) of the Federal Trade Commission Act prohibits “unfair or deceptive acts or practices in or affecting commerce.” Per the rule, unfair practices are those that cause, or are likely to cause, injury to consumers, those that consumers cannot avoid, and those in which the benefits of the product or service do not outweigh the deception. Deceptive practices are defined as those in which the seller misrepresents or misleads the consumer, and the misleading practice is substantial.

The Federal Trade Commission (FTC) is a federal agency that enforces consumer protection laws. Consumers may seek recourse for unfair trade practices by suing for compensatory or punitive damages. Plaintiffs do not have to prove intent. Showing that the practice itself was unfair or deceptive is sufficient.



Figure 9.1.1: The Federal Trade Commission (FTC) enforces consumer protection laws. (Credit: U.S. Government/wikimedia/ License: Public Domain)

Unfair Trade Practices and Examples

Product Guarantees and False Endorsements

Companies must be prepared to honor product guarantees. For example, if a product is advertised with a 50 percent money-back guarantee, then that must be provided to customers who meet the requirement(s) attached to the guarantee. Similarly, companies may not create false endorsements and testimonials about their products.

Unfair Advertising

False advertising includes the misrepresentation of a product, service, or price. It may be more expansively defined to include unfair sales strategies, such as advertising one item and then selling another item in its place, e.g., one that is higher priced, lower quality, and/or less in demand. This method is most commonly referred to as “bait and switch.” Additional examples of unfair advertising include incorrect pricing, fake endorsements, deceptive guarantees, making false statements, and providing descriptions that exaggerate the performance of the product or service.

✓ Example 9.1.1

For months, Ivan had searched for just the right window curtain to match the décor of his new high-rise condo. Finally, while browsing through Amazon, he saw two gray velvet curtains that featured a damask pattern, with taupe and gold accents and specks of ice blue glitter accents. He could not have designed a more perfect color palette for the window treatments if he tried.

Moreover, the velvet blackout touch was just what he needed. Excited, he hit the “Buy Now” button and waited a couple of days for his order to arrive. When it did, what a huge disappointment! He could see, if he stared long and hard enough, how someone with a vivid imagination might consider the curtain to be an abstract interpretation of what was advertised. However, most people would see that the product was not at all close to what was advertised. The velvet was closer to linen, the damask pattern was closer to swirls, and the taupe and gold accents with specks of ice blue were closer to silver and purple, with specks of mauve. After running a Google reverse image search of the original product photo, he saw it featured in an interior design magazine. When Ivan looked up the product endorsements and reviews, he saw that all of the reviewers had only posted reviews for that particular seller’s products, and that they had posted nothing but glowing reviews for each of the products. It was clear to Ivan that the seller was guilty of false advertising, as well as faking endorsements. Ivan has enough information to submit a consumer complaint to the Federal Trade Commission.

Taking Advantage of Customers

The FTC also pays particular attention to business ventures that target vulnerable populations. For example, some telemarketing efforts employ intense pressuring tactics to target seniors and people who don’t speak English.

✓ Example 9.1.2

Devin is involved in the telemarketing of spy gadgets, such as bugs and bug detectors. He has had a lot of trouble finding a market for these products. One day, he speaks with an older citizen who asks him about the benefits of the bug detector. Devin starts to knowingly make unsubstantiated claims that there have been news reports that home bugging is on the rise. His false claims work like a charm. Spooked, the elderly customer buys the most expensive bug detector product. Seeing his success, Devin purchases a report of households in his geographic selling area that are headed by people over the age of 70. Over the next few months, his sales increase at an explosive rate. When he is recognized by management for his leading sales numbers, they also inquire about the secret to his success as they seek to replicate it in training materials for other sales professionals. When Devin proudly explains his tactics, he is terminated by the company. The company calls the customers impacted by his false claims, explains that there was a misrepresentation by one of their sales associates regarding the scope of known bugging activity, allows them to keep their bug detectors, and refunds them the money they spent purchasing the products. The sales associate engaged in unfair trade practices, but the company took appropriate steps to correct it.

Misrepresenting a Product

At times, the FTC may be quite technical in its definition of certain terms. For this reason, companies should be very clear about their usage of various phrases and words. For example, the word “new” may only be used to refer to a product that is less than six months old. Other terms may be the subject of debate or litigation, such as whether a lotion will actually “rejuvenate” skin or whether a tablet will actually “cure” baldness. Indeed, a sweater should not be called “wool” unless that is its complete composition. There are many examples, so it is important for businesses to have an understanding of the FTC’s rules on this topic.

Giving Misleading Price Information

The FTC sanctions misleading price information as an unfair trade practice. Examples of misleading price information include false sales in which a “limited time offer” might actually be available forever, or running a “Going Out of Business” sale without any plans to go out of business, while advertising that items are discounted, although the prices have not changed.

✓ Example 9.1.3

A brick-and-mortar store has an online promotion for a “buy one, get one” offer for the season’s hottest new phone, stating that the offer is only available on Black Friday. The store opens at 5:00 a.m., and customers start lining up with their sleeping bags in tow the evening prior to the morning opening time. After customers almost stampede one another, they learn that they will also have to purchase a phone plan that is inflated by 100% of its regular price to qualify for the deal. Nowhere in the literature or promotions was the phone plan, or its over-inflated price, mentioned as a requirement to get the buy one get one free phone deal.

Failing to Disclose Pertinent Information

Merchants must disclose facts that would reasonably influence the consumer's decision to make a purchase. Withholding pertinent information from customers may be viewed by the FTC as equal in severity to the process of using overtly incorrect or deceptive information. For example, sellers should always disclose the full price of their products or services before accepting payment for them.

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9.2: The Federal Trade Commission

The FTC was created in 1914 to address the problem of monopolies and trusts. Following the Civil War, a wave of consolidation and growth among companies triggered increased public debate. Through handshake agreements, issuance of stock, and pooling arrangements, companies could fix prices and outputs, thus effectively stopping competition and raising consumer prices. A substantial number of mergers gave control over key industries to small groups of businesses. Where companies did not merge, other arrangements were made to have a similar effect. Conglomerates controlled most of the relevant industries that produced household necessities. Goods used in production were also the product of highly concentrated trusts, such as the United States Steel Corporation and the International Paper Company. Concerns about industrialization and a changing economy, with shifting norms for personal lives, triggered antitrust sentiment.



Figure 9.2.1: The Federal Trade Commission prevents monopolies, like that of U.S. Steel in the early 20th century. (Credit: Bruce McAllister/ wikimedia/ License: Public Domain)

The perceived unfairness and fears caused by the consolidation of businesses created strong anti-business sentiment and increasing cries for price controls to be considered as a remedy for heavily concentrated industries. These organizations posed economic and social problems that became a large social concern. In response, the Federal Trade Commission (FTC) was created with broad powers to investigate and propose formal recommendations to companies about their competitive practices. The FTC did not formally have a consumer protection mission until the passage of the Wheeler-Lea Act in 1938. This act gave the FTC the power to combat false advertising for any foods, drugs, medical devices, or cosmetics.

In addition to the Wheeler-Lea Act, subsequent amendments to the FTC Act, as well as judicial respect toward the agency, broadened the power and jurisdiction of the FTC.

Today, in addition to its original antitrust roots, the FTC enforces consumer protection laws.

Bureaus of the FTC

Several bureaus now stand in support of the FTC's efforts.

Bureau of Consumer Protection

The Bureau of Consumer Protection protects consumers against unfair trade practices. Bureau attorneys enforce consumer protection laws issued by the FTC. In addition to enforcement actions, the Bureau's functions include investigations and consumer and business training. Unfair trade practices in advertising and marketing are a main focus, as well as privacy, financial products and practices, and identity protection. The Bureau also manages the United States National Do Not Call Registry and investigates telemarketing fraud.

Bureau of Competition

The Bureau of Competition's purpose is to eliminate and prevent "anticompetitive" business practices related to the enforcement of antitrust laws. The FTC and the Department of Justice share responsibility for the enforcement of antitrust laws.

Bureau of Economics

The Bureau of Economics supports the Bureau of Competition and the Bureau of Consumer Protection by providing subject matter expertise regarding the economic impacts of FTC legislative activity.

FTC Activities

The FTC investigates issues raised through a number of sources, including consumer, business, and media reports. If the FTC concludes that there was unlawful conduct, it may seek several forms of recourse. These include the pursuit of voluntary compliance through a consent order, the submission and filing of administrative complaints, or the initiation of a federal action and litigation.

The FTC has the power to create rules regarding widespread industry practices. Rules created in this fashion to address systemic issues are called trade rules.

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9.3: Liability Under the Securities Act

Many companies were initially irritated by the creation of the Securities Exchange Act of 1934 because it created many legal responsibilities and possible liabilities that affected their business models. Over time, most companies came to recognize that they needed legal counsel and strong internal systems to stay in compliance with these laws.

The costs of not complying with the Exchange Act are serious. The SEC can seek monetary fines, civil penalties, orders to return illegal profits, and—if the conduct is severe enough—criminal authorities can bring charges that may lead to prison time. Insider trading is one of the best-known violations that can result in both civil and criminal penalties.

In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, which strengthened the enforcement powers of the SEC after the 2008 financial crisis. Dodd-Frank allows the SEC to seek higher penalties in more cases and expanded its reach over a wider range of market participants, including advisers to hedge funds and other private funds. This means the risk of enforcement for serious violations, including insider trading and disclosure failures, has grown over time.

✓ Example 9.3.1

The Dodd-Frank Act and Securities Regulation

In 2010, after the 2008 financial crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. The law's goals included promoting financial stability, ending “too big to fail,” and strengthening protections for investors and consumers.

For securities regulation, Dodd-Frank did several important things:

- Gave the SEC more power to write rules and bring enforcement actions in new areas, such as derivatives and asset-backed securities.
- Required securitizers of many asset-backed securities to keep at least 5 percent of the credit risk (“skin in the game”) instead of passing all the risk to investors.
- Created new investor-focused offices inside the SEC, including an Investor Advisory Committee and an Office of the Investor Advocate, to give everyday investors a stronger voice.
- Expanded whistleblower incentives, offering financial rewards to people who report securities law violations to the SEC.

Dodd-Frank did not replace the Securities Exchange Act of 1934. Instead, it layered new tools and protections on top of the existing framework, making the SEC a more powerful regulator of modern financial markets.

Insider Trading

While laws vary from country to country, **insider trading** in the United States is generally understood in line with the SEC's view: it occurs when someone buys or sells a security in breach of a fiduciary duty or other relationship of trust and confidence while in possession of **material, nonpublic information** about that security. A **fiduciary** is a person who must act in the best interests of someone else, such as a corporate officer acting for the benefit of the company and its shareholders.

In a business, directors, officers, and some employees may know important facts before the public does—for example, an upcoming merger, a major new product, or a serious legal problem. If that information is “material,” meaning a reasonable investor would consider it important in deciding whether to buy or sell the stock, it must not be used for personal gain until it has been disclosed to the public. Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 prohibit the purchase or sale of securities on the basis of material nonpublic information obtained in violation of a duty of trust and confidence.

The directors, large shareholders, and officers of companies frequently have access to this kind of nonpublic information. While an individual, rather than the whole company, is usually charged as an insider trader, such charges can damage the company's reputation and erode investor trust.

✓ Example 9.3.1

The Martha Stewart ImClone Insider Trading Case

The ImClone case involving Martha Stewart is a well-known example of alleged insider trading and how it can affect both individuals and public companies.

In December 2001, Stewart owned nearly 4,000 shares of ImClone Systems, a biopharmaceutical company. Her broker, Peter Bacanovic, learned that ImClone's CEO, Sam Waksal, and Waksal's family members were selling large amounts of ImClone stock, and this information was not yet public. Based on this tip, Stewart instructed that all of her ImClone shares be sold.

The very next day, ImClone announced that the Food and Drug Administration (FDA) had refused to accept its application for a new cancer drug, Erbitux, and the stock price fell about 16 percent. By selling early, Stewart avoided losses of roughly \$45,673. The SEC later charged Stewart and Bacanovic with violating the antifraud provisions of the federal securities laws, alleging that Stewart traded on material nonpublic information and then helped create a false explanation for the trade.

Stewart ultimately settled the SEC's charges, agreeing to give up the losses she avoided, pay a civil penalty, and accept a five-year bar from serving as a director of a public company, along with limits on serving as an officer. The case illustrates that insider trading allegations can lead to serious financial and reputational consequences, especially when they involve well-known business leaders.



Figure 9.3.1: Insider trading can result in criminal conviction and possibly jail time. (Credit: Suzy Hazelwood/ pexels/ License: CC0)

Insider trading is not always illegal. For example, corporate insiders such as officers and directors can legally buy and sell their company's stock so long as they follow the disclosure rules and do not trade while in possession of material nonpublic information. One way they can do this is by using **pre-arranged trading plans**. Under SEC Rule 10b5-1, executives at public companies may adopt written trading plans in good faith that set pre-determined dates, amounts, or formulas for trades before they know any new inside information. When trades are carried out strictly according to these plans, and the plans meet SEC conditions, insiders receive a form of **"safe harbor"**, limited protection from insider trading accusations for those pre-planned trades.

Schedule 13D

In 1968, the Williams Act amended the Securities Exchange Act of 1934 to give investors advance warning of possible corporate takeovers. If an individual or entity becomes the beneficial owner of more than 5 percent of a company's voting stock, that owner must file a Schedule 13D with the SEC within 10 days of crossing that threshold. A **beneficial owner** is anyone with voting power or the power to decide how the shares will be invested.

There are limited exceptions. For example, certain qualified institutional investors, such as insurance companies, some investment companies, and state employee benefit plans, can report their holdings on a different schedule, because they are considered more sophisticated and in less need of detailed takeover-warning disclosures.

Insider Transactions

Corporate insiders include officers, directors, and beneficial owners of more than 10 percent of a class of a company's registered equity securities. These insiders must file statements of ownership and report their trades in the company's securities to the SEC so that the market can see when insiders are buying or selling.

In 2002, the SEC adopted rules that shortened the reporting deadline for insider trades, requiring most insider transactions in equity securities to be reported within two business days. It is important for a company to have strong internal controls to make sure insiders know these rules and report their trades on time. A company that fails to adopt and enforce effective compliance procedures can face reputational harm and, in some cases, regulatory problems because of its insiders' violations.

Reporting Requirements

Publicly owned companies that meet certain size and shareholder thresholds are called **reporting companies**, and under Section 13(a) of the Securities Exchange Act of 1934, they must file ongoing reports with the SEC. The goal of these disclosures is to help investors make informed decisions about where to put their money.

These reports include information about the company's business, risk factors, corporate officers and directors, and detailed financial statements. Over time, the SEC has updated its reporting rules to require more discussion of topics such as market risks, internal controls, and significant legal proceedings, so that investors can better understand the company's overall condition.

Form 10-K

Form 10-K is the company's annual report filed with the SEC and contains audited financial statements. Audited financial statements are reviewed by independent certified public accountants (CPAs) who are not part of the company and who give an opinion on whether the financial statements fairly present the company's results in accordance with Generally Accepted Accounting Principles (GAAP).

When the Exchange Act was first passed, many companies provided only the minimum information required. Over time, companies began using their annual reports not just to comply with SEC rules but also to tell their story and attract investors. Today, many annual reports include required financial data plus narratives about the company's mission, strategy, and view of the broader economy. The Form 10-K is a major responsibility because it must discuss the company's financial condition, results of operations, significant risks, internal controls, major legal matters, defaults, and other key information investors need.

Form 10-Q

Form 10-Q is the company's quarterly report. It includes unaudited financial statements and other updates for the quarter. Because these statements are not audited, they are less costly and faster to prepare, but investors do not get the extra assurance that comes with an auditor's opinion.

Form 8-K

Form 8-K is used to report certain important events, such as changes in top officers, mergers, major asset sales, or bankruptcy filings. Companies must file Form 8-K within four business days of many types of significant events, so that investors receive timely information about major changes.

Proxy Statements

Proxy statements are documents that shareholders of companies with securities registered under Section 12 of the Exchange Act receive so they can vote on directors and other important corporate matters. Even shareholders who own only one share are entitled to receive proxy materials.

Sending proxy materials to all shareholders is a large project, so many companies now send a "Notice of Internet Availability of Proxy Materials" that explains how to access the full proxy statement and related documents online. The notice must reach shareholders at least 40 days before the meeting, which helps ensure investors have enough time to review the information before voting.

Ongoing Responsibilities

Businesses must stay current with changes in securities laws that affect their responsibilities and potential liabilities. The Exchange Act gives the SEC the authority to adopt new rules and update old ones as markets and technology change. For example, in 2000, the SEC adopted Regulation FD ("fair disclosure"), which is designed to prevent companies from giving important information to select analysts or investors before sharing it with the general public.^{sec+3}

In 2013, the SEC clarified that companies may use social media outlets such as Facebook and Twitter to announce important information, as long as investors have been told in advance which social media channels the company will use and the information is broadly accessible. This guidance applies the same fair-disclosure principles to new communication technologies as to company websites and press releases.

Dodd-Frank also created new oversight and reporting requirements in areas like derivatives, asset-backed securities, credit rating agencies, and executive compensation, and it directed the SEC and other regulators to adopt many new rules to strengthen transparency and investor protection. As a result, companies today face a more complex but also more robust system of securities regulation than in earlier decades.

Summary

This section has provided an overview of some of the most important ongoing duties under the Securities Exchange Act of 1934, as strengthened by later laws such as the Dodd-Frank Act. Given the many exceptions and technical details in securities law, and the speed of change in both financial markets and technology, successful companies need competent legal counsel and strong compliance systems to navigate SEC requirements. Some violations, like intentional insider trading, involve clear misconduct, but others can occur because insiders or employees simply misunderstand or overlook complex rules. Either way, the consequences can be serious for both individuals and the companies they represent.

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9.4: The Framework of Securities Regulation

The Securities Exchange Act of 1934

In 1929, the United States stock market crashed and lost \$25 billion, which would be approximately \$319 billion today. The Stock Market crash of 1929 was one cause of the American Great Depression of the 1930s, which caused the failure of nearly half of American banks and created unemployment rates of almost 25 percent by 1933. These dire economic conditions created the need for breadlines, quite literally, hungry people who waited in line at charitable and government organizations for loaves of bread, and shanty towns, or areas where families who had lost their homes lived in cloistered tents on the outskirts of cities. Farmers could not even afford to harvest their crops.



Figure 9.4.1: Florence Owens Thompson and her children were living on frozen vegetables and birds they killed in this famous photograph taken in 1936 in California. (Credit: Dorothea Lange/ wikimedia/ License: Public Domain)

It was amid this social and economic unrest that Congress passed the Securities Exchange Act of 1934. Signed by President Franklin D. Roosevelt, the Securities Exchange Act of 1934 recognized that the stock market crash of 1929 was caused by wild speculation, large and sudden fluctuations, and manipulations involving securities. An article in the 1934 **California Law Review** described the condition of the market at the time by writing, “Artificial prices of securities were the rule rather than the exception.... The result was vast economic power, with all that implies in a democracy, in the hands of men whose ethical standards were substantially those of gangsters.”

Roosevelt wanted to enact legislation to try to prevent this wild speculation in securities from happening again and to restore the public’s faith. He recognized that stock market crashes would not only destroy wealth in securities markets, but they were also instrumental to the financial security of the nation as a whole. The passing of the Securities Exchange Act of 1934 was not only a reaction to the market crash, but it also represented a broad shift in the social and economic paradigms and legal frameworks of the United States. Previously, the United States had largely followed a **laissez-faire** economic policy. Laissez-faire, as popularized by Scottish economist Adam Smith and British philosopher Herbert Spencer, describes an economic philosophy that markets function best when left to their own devices, i.e., without, or with minimal, government involvement or regulations. The rejection of laissez-faire was part of a larger social shift that opposed the long hours, unsafe working conditions, and child labor that had become commonplace as a result of the Industrial Revolution.

The SEC

Section 4 of the Securities Exchange Act of 1934 created the **Securities and Exchange Commission (SEC)** to enforce its ongoing mission. The SEC is an independent agency of the United States federal government. It regulates securities laws and regulations. The first chairperson of the SEC was Joseph P. Kennedy, the father of President John F. Kennedy. The SEC is led by five presidentially appointed commissioners and has five divisions: Division of Corporation Finance, Division of Investment Management, Division of Trading and Markets, Division of Enforcement, and Division of Economic and Risk Analysis.

The SEC also oversees **self-regulatory organizations (SROs)**, or private organizations that create and enforce industry standards. These organizations are allowed to “police” themselves, but are subject to compliance with SEC regulations. The various well-known securities exchanges, such as the New York Stock Exchange (NYSE), the National Association of Securities Dealers Automated Quotation System (NASDAQ), and the Chicago Board of Options Exchange, are SROs. Per Section 12(g), companies

with total assets exceeding \$10 million and with 500 or more owners of any class of securities must register with the SEC unless they meet exemption requirements.

The SEC makes new laws in response to emerging technologies. For example, Title III of the Jumpstart Our Business Startups (JOBS) Act of 2012 was added, and in it, Section 4(a)(6) allows **crowdfunding**, or raising small amounts of money from many people to fund a venture or project, usually over the internet. Crowdfunding transactions are exempt from registration as long as the amount raised does not exceed \$1,070,000 in a 12-month period.

Secondary Markets

The Securities Exchange Act of 1934 governs **secondary markets**, or what is typically referred to as the “stock market.” In contrast to the **primary market**, which involves the **initial** sale of a security, such as through an **initial public offering (IPO)**, secondary markets involve subsequent buyers and sellers of securities. One key difference is that primary market prices are set in advance, while secondary market prices are subject to constantly changing market valuations, as determined by supply and demand and investor expectations. For example, when Facebook initiated its IPO in May of 2012, the price was \$38 per share, and technical issues on the NASDAQ complicated the offering. After the IPO, the stock traded **sideways**, meaning that it stayed within a range that did not indicate strong upward or downward movement. However, Facebook has gone on to trade at values more than four times its initial IPO valuation, due to investor beliefs and expectations. Not all stocks go up in value after their IPO; some vacillate between highs and lows and frustrate investors with their unstable valuation swings.



Figure 9.4.2: Stocks on the secondary market fluctuate in value. (Credit: 3844328/ pixabay/ License: CC0)

Reporting Requirements

The Securities Exchange Act of 1934 created numerous reporting requirements for public companies. The purpose of these requirements was **transparency**, that is, keeping the public up to date and informed of changes that might impact securities prices. Public companies with securities registered under Section 12 or that are subject to Section 15(d) must file reports with the SEC. Section 12 requires the registration of certain securities and outlines the procedures necessary to do so. Information required by Section 12 includes the nature of the business, its financial structure, the different classes of securities, the names of officers and directors, along with their salaries and bonus arrangements, and financial statements. Section 15 requires brokers and dealers to register with the SEC. Individuals who buy and sell securities are considered traders and, therefore, are not subject to filing under Section 15. Section 15(d) requires registered companies to file periodic reports, such as the annual Form 10-K and the quarterly Form 10-Q. These reports will be explained in detail in the next section of this chapter. The SEC Commission makes these reports available to all investors through the EDGAR website to help them make informed investment decisions.

Registration Requirements

The Securities Act of 1933 required companies initiating securities offers and exchanges to register with the SEC, unless they met exemption criteria. Section 5 of the Securities Exchange Act of 1934 built upon this foundation and made it unlawful to transact on unregistered exchanges and specifically extended this regulation to the usage of the mail and interstate commerce. 15 U.S. Code § 78f states that exchanges must not only register with the SEC, but they must also have rules that “prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest ...”

Blue Sky Laws

When the Securities Exchange Act is discussed, blue sky laws are often mentioned. In 1911, Kansas bank commissioner J.N. Dolley became concerned about what he called “swindles,” in which investors at the time lost money by investing in “fake mines” or “a Central American plantation that was nine parts imagination.” Therefore, he lobbied for the first “comprehensive” securities law in the United States because, as he phrased it, these investments were backed by nothing except the blue skies of Kansas. So, state-level securities laws aimed to combat fraud are called blue sky laws. The SEC does not have jurisdiction over activities within states and does not enforce blue sky laws.



Figure 9.4.3: In addition to the Securities Exchange Act of 1934, blue sky laws provide an additional state-level layer of legal protection for the public. (Credit: Elia Clerici/ pexels/ License: CC0)

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