BUS 105/LAW 105: THE LEGAL ENVIRONMENT OF BUSINESS



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BUS 105/LAW 105

The Legal Environment of Business

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CHAPTER OVERVIEW

1: Law and Legal Systems

Learning Objectives

After reading this chapter, you should understand the following:

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

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

1.1: What Is Law?

1.2: Schools of Legal Thought

1.3: Basic Concepts and Categories of US Positive Law

1.4: Sources of Law and Their Priority

1.5: Legal and Political Systems of the World

1.6: Summary and Exercises

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1.1: What Is Law?

Law is a word that means different things at different times. *Black's Law Dictionary* says that law is "a body of rules of action or conduct prescribed by controlling authority, and having binding legal force. That which must be obeyed and followed by citizens subject to sanctions or legal consequence is a law."*Black's Law Dictionary*, 6th ed., s.v. "law."

Functions of the Law

In a nation, the law can serve to (1) keep the peace, (2) maintain the status quo, (3) preserve individual rights, (4) protect minorities against majorities, (5) promote social justice, and (6) provide for orderly social change. Some legal systems serve these purposes better than others. Although a nation ruled by an authoritarian government may keep the peace and maintain the status quo, it may also oppress minorities or political opponents (e.g., Burma, Zimbabwe, or Iraq under Saddam Hussein). Under colonialism, European nations often imposed peace in countries whose borders were somewhat arbitrarily created by those same European nations. Over several centuries prior to the twentieth century, empires were built by Spain, Portugal, Britain, Holland, France, Germany, Belgium, and Italy. With regard to the functions of the law, the empire may have kept the peace—largely with force—but it changed the status quo and seldom promoted the native peoples' rights or social justice within the colonized nation.

In nations that were former colonies of European nations, various ethnic and tribal factions have frequently made it difficult for a single, united government to rule effectively. In Rwanda, for example, power struggles between Hutus and Tutsis resulted in genocide of the Tutsi minority. (Genocide is the deliberate and systematic killing or displacement of one group of people by another group. In 1948, the international community formally condemned the crime of genocide.) In nations of the former Soviet Union, the withdrawal of a central power created power vacuums that were exploited by ethnic leaders. When Yugoslavia broke up, the different ethnic groups—Croats, Bosnians, and Serbians—fought bitterly for home turf rather than share power.

Law and Politics

In the United States, legislators, judges, administrative agencies, governors, and presidents make law, with substantial input from corporations, lobbyists, and a diverse group of nongovernment organizations (NGOs) such as the American Petroleum Institute, the Sierra Club, and the National Rifle Association. In the fifty states, judges are often appointed by governors or elected by the people. The process of electing state judges has become more and more politicized in the past thirty years, with growing campaign contributions from those who would seek to seat judges with similar political leanings.

In the federal system, judges are appointed by an elected official (the president) and confirmed by other elected officials (the Senate). If the president is from one party and the other party holds a majority of Senate seats, political conflicts may come up during the judges' confirmation processes. Such a division has been fairly frequent over the past forty years.

In most nation-states (as countries are called in international law), knowing who has power to make and enforce the laws is a matter of knowing who has political power; in many places, the people or groups that have military power can also command political power to make and enforce the laws. Revolutions are difficult and contentious, but each year there are revolts against existing political-legal authority; an aspiration for democratic rule, or greater "rights" for citizens, is a recurring theme in politics and law.

Key Takeaway

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

Exercises

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

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1.2: Schools of Legal Thought

Learning Objectives

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

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

There are different schools (or philosophies) concerning what law is all about. Philosophy of law is also called jurisprudence, and the two main schools are legal positivism and natural law. Although there are others (see Section 1.2.3 "Other Schools of Legal Thought"), these two are the most influential in how people think about the law.

Legal Positivism: Law as Sovereign Command

As legal philosopher John Austin concisely put it, "Law is the command of a sovereign." Law is only law, in other words, if it comes from a recognized authority and can be enforced by that authority, or sovereign—such as a king, a president, or a dictator—who has power within a defined area or territory. Positivism is a philosophical movement that claims that science provides the only knowledge precise enough to be worthwhile. But what are we to make of the social phenomena of laws?

We could examine existing statutes—executive orders, regulations, or judicial decisions—in a fairly precise way to find out what the law says. For example, we could look at the posted speed limits on most US highways and conclude that the "correct" or "right" speed is no more than fifty-five miles per hour. Or we could look a little deeper and find out how the written law is usually applied. Doing so, we might conclude that sixty-one miles per hour is generally allowed by most state troopers, but that occasionally someone gets ticketed for doing fifty-seven miles per hour in a fifty-five miles per hour zone. Either approach is empirical, even if not rigorously scientific. The first approach, examining in a precise way what the rule itself says, is sometimes known as the "positivist" school of legal thought. The second approach—which relies on social context and the actual behavior of the principal actors who enforce the law—is akin to the "legal realist" school of thought (see Section 1.2.3 "Other Schools of Legal Thought").

Positivism has its limits and its critics. New Testament readers may recall that King Herod, fearing the birth of a Messiah, issued a decree that all male children below a certain age be killed. Because it was the command of a sovereign, the decree was carried out (or, in legal jargon, the decree was "executed"). Suppose a group seizes power in a particular place and commands that women cannot attend school and can only be treated medically by women, even if their condition is life-threatening and women doctors are few and far between. Suppose also that this command is carried out, just because it is the law and is enforced with a vengeance. People who live there will undoubtedly question the wisdom, justice, or goodness of such a law, but it is law nonetheless and is generally carried out. To avoid the law's impact, a citizen would have to flee the country entirely. During the Taliban rule in Afghanistan, from which this example is drawn, many did flee.

The positive-law school of legal thought would recognize the lawmaker's command as legitimate; questions about the law's morality or immorality would not be important. In contrast, the natural-law school of legal thought would refuse to recognize the legitimacy of laws that did not conform to natural, universal, or divine law. If a lawmaker issued a command that was in violation of natural law, a citizen would be morally justified in demonstrating civil disobedience. For example, in refusing to give up her seat to a white person, Rosa Parks believed that she was refusing to obey an unjust law that required racial segregation of bus seating.

Natural Law

The natural-law school of thought emphasizes that law should be based on a universal moral order. Natural law was "discovered" by humans through the use of reason and by choosing between that which is good and that which is evil. Here is the definition of natural law according to the *Cambridge Dictionary of Philosophy*: "Natural law, also called the law of nature in moral and political philosophy, is an objective norm or set of objective norms governing human behavior, similar to the positive laws of a human ruler,

but binding on all people alike and usually understood as involving a superhuman legislator."*Cambridge Dictionary of Philosophy*, s.v. "natural law."

Both the US Constitution and the United Nations (UN) Charter have an affinity for the natural-law outlook, as they emphasize certain objective norms and rights of individuals and nations. The US Declaration of Independence embodies a natural-law philosophy. The following short extract from the declaration provides some sense of the deep beliefs in natural law held by those who signed the document:

July 4, 1776

When in the Course of human events, it becomes necessary for one people to dissolve the political bands which have connected them with another, and to assume among the powers of the earth, the separate and equal station to which the Laws of Nature and of Nature's God entitle them, a decent respect to the opinions of mankind requires that they should declare the causes which impel them to the separation.

We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the Pursuit of Happiness. That to secure these rights, Governments are instituted among Men, deriving their just powers from the consent of the governed.…

The natural-law school has been very influential in American legal thinking. The idea that certain rights, for example, are "unalienable" (as expressed in the Declaration of Independence and in the writings of John Locke) is consistent with this view of the law. Individuals may have "God-given" or "natural" rights that government cannot legitimately take away. Government only by consent of the governed is a natural outgrowth of this view.

Civil disobedience—in the tradition of Henry Thoreau, Mahatma Gandhi, or Martin Luther King Jr.—becomes a matter of morality over "unnatural" law. For example, in his "Letter from Birmingham Jail," Martin Luther King Jr. claims that obeying an unjust law is not moral and that deliberately disobeying an unjust law is in fact a moral act that expresses "the highest respect for law": "An individual who breaks a law that conscience tells him is unjust, and who willingly accepts the penalty of imprisonment in order to arouse the conscience of the community over its injustice, is in reality expressing the highest respect for law.…One who breaks an unjust law must do so openly, lovingly, and with a willingness to accept the penalty." (Martin Luther King Jr., "Letter from Birmingham Jail.")

Legal positivists, on the other hand, would say that we cannot know with real confidence what "natural" law or "universal" law is. In studying law, we can most effectively learn by just looking at what the written law says, or by examining how it has been applied. In response, natural-law thinkers would argue that if we care about justice, every law and every legal system must be held accountable to some higher standard, however hard that may be to define.

It is easier to know what the law "is" than what the law "should be." Equal employment laws, for example, have specific statutes, rules, and decisions about racial discrimination. There are always difficult issues of interpretation and decision, which is why courts will resolve differing views. But how can we know the more fundamental "ought" or "should" of human equality? For example, how do we *know* that "all men are created equal" (from the Declaration of Independence)? Setting aside for the moment fundamental questions about the equality of women, or that of slaves, who were not counted as men with equal rights at the time of the declaration—can the statement be empirically proven, or is it simply a matter of a priori knowledge? (*A priori* means "existing in the mind prior to and independent of experience.") Or is the statement about equality a matter of faith or belief, not really provable either scientifically or rationally? The dialogue between natural-law theorists and more empirically-oriented theories of "what law is" will raise similar questions. In this book, we will focus mostly on the law as it is, but not without also raising questions about what it could or should be.

Other Schools of Legal Thought

The historical school of law believes that societies should base their legal decisions today on the examples of the past. Precedent would be more important than moral arguments.

The legal realist school flourished in the 1920s and 1930s as a reaction to the historical school. Legal realists pointed out that because life and society are constantly changing, certain laws and doctrines have to be altered or modernized in order to remain current. The social context of law was more important to legal realists than the formal application of precedent to current or future

legal disputes. Rather than suppose that judges inevitably acted objectively in applying an existing rule to a set of facts, legal realists observed that judges had their own beliefs, operated in a social context, and would give legal decisions based on their beliefs and their own social context.

The legal realist view influenced the emergence of the critical legal studies (CLS) school of thought. Those who adopt CLS believe that the social order (and the law) is dominated by those with power, wealth, and influence. Some CLS theorists are clearly influenced by the economist Karl Marx and also by distributive justice theory (see Chapter 2). The CLS school believes the wealthy have historically oppressed or exploited those with less wealth and have maintained social control through law. In so doing, the wealthy have perpetuated an unjust distribution of both rights and goods in society. Law is politics and is thus not neutral or value-free. The CLS movement would use the law to overturn the hierarchical structures of domination in the modern society.

Related to the CLS school, yet different, is the ecofeminist school of legal thought. This school emphasizes—and would modify—the long-standing domination of men over both women and the rest of the natural world. Ecofeminists would say that the same social mentality that leads to exploitation of women is at the root of man's exploitation and degradation of the natural environment. They would say that male ownership of land has led to a "dominator culture," in which man is not so much a steward of the existing environment or those "subordinate" to him but is charged with making all that he controls economically "productive." Wives, children, land, and animals are valued as economic resources, and legal systems (until the nineteenth century) largely conferred rights only to men with land. Ecofeminists would say that even with increasing civil and political rights for women (such as the right to vote) and with some nations' recognizing the rights of children and animals and caring for the environment, the legacy of the past for most nations still confirms the preeminence of "man" and his dominance of both nature and women.

Key Takeaway

Each of the various schools of legal thought has a particular view of what a legal system is or what it should be. The natural-law theorists emphasize the rights and duties of both government and the governed. Positive law takes as a given that law is simply the command of a sovereign, the political power that those governed will obey. Recent writings in the various legal schools of thought emphasize long-standing patterns of domination of the wealthy over others (the CLS school) and of men over women (ecofeminist legal theory).

Exercises

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

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1.3: Basic Concepts and Categories of US Positive Law

Learning Objectives

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

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

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

Law: The Moral Minimums in a Democratic Society

The law does not correct (or claim to correct) every wrong that occurs in society. At a minimum, it aims to curb the worst kind of wrongs, the kinds of wrongs that violate what might be called the “moral minimums” that a community demands of its members. These include not only violations of criminal law (see Chapter 6) but also torts (see Chapter 7) and broken promises (see Chapter 8). Thus it may be wrong to refuse to return a phone call from a friend, but that wrong will not result in a viable lawsuit against you. But if a phone (or the Internet) is used to libel or slander someone, a tort has been committed, and the law may allow the defamed person to be compensated.

There is a strong association between what we generally think of as ethical behavior and what the laws require and provide. For example, contract law upholds society’s sense that promises—in general—should be kept. Promise-breaking is seen as unethical. The law provides remedies for broken promises (in breach of contract cases) but not for all broken promises; some excuses are accepted when it would be reasonable to do so. For tort law, harming others is considered unethical. If people are not restrained by law from harming one another, orderly society would be undone, leading to anarchy. Tort law provides for compensation when serious injuries or harms occur. As for property law issues, we generally believe that private ownership of property is socially useful and generally desirable, and it is generally protected (with some exceptions) by laws. You can’t throw a party at my house without my permission, but my right to do whatever I want on my own property may be limited by law; I can’t, without the public’s permission, operate an incinerator on my property and burn heavy metals, as toxic ash may be deposited throughout the neighborhood.

The Common Law: Property, Torts, and Contracts

Even before legislatures met to make rules for society, disputes happened and judges decided them. In England, judges began writing down the facts of a case and the reasons for their decision. They often resorted to deciding cases on the basis of prior written decisions. In relying on those prior decisions, the judge would reason that since a current case was pretty much like a prior case, it ought to be decided the same way. This is essentially reasoning by analogy, but it also reflects a sense of "equal justice under law." (The phrase engraved at the entrance of the US Supreme Court building). Thus the use of precedent in common-law cases came into being, and a doctrine of stare decisis (pronounced STAR-ay-de-SIGH-sus) became accepted in English courts. *Stare decisis* means, in Latin, “let the decision stand.”

Most judicial decisions that don’t apply legislative acts (known as statutes) will involve one of three areas of law—property, contract, or tort. Property law deals with the rights and duties of those who can legally own land (real property), how that ownership can be legally confirmed and protected, how property can be bought and sold, what the rights of tenants (renters) are, and what the various kinds of “estates” in land are (e.g., fee simple, life estate, future interest, easements, or rights of way). Contract law deals with what kinds of promises courts should enforce. For example, should courts enforce a contract where one of the parties was intoxicated, underage, or insane? Should courts enforce a contract where one of the parties seemed to have an unfair advantage? What kind of contracts would have to be in writing to be enforced by courts? Tort law deals with the types of cases that involve some kind of harm and or injury between the plaintiff and the defendant when no contract exists. Thus if you are libeled or a competitor lies about your product, your remedy would be in tort, not contract.

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

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

State Courts and the Domain of State Law

In the early years of our nation, federal courts were not as active or important as state courts. States had jurisdiction (the power to make and enforce laws) over the most important aspects of business life. The power of state law has historically included governing the following kinds of issues and claims:

- Contracts, including sales, commercial paper, letters of credit, and secured transactions
- Torts
- Property, including real property, bailments of personal property (such as when you check your coat at a theater or leave your clothes with a dry cleaner), trademarks, copyrights, and the estates of decedents (dead people)
- Corporations
- Partnerships
- Domestic matters, including marriage, divorce, custody, adoption, and visitation
- Securities law
- Environmental law
- Agency law, governing the relationship between principals and their agents
- Banking
- Insurance

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

Civil versus Criminal Cases

Most of the cases we will look at in this textbook are civil cases. Criminal cases are certainly of interest to business, especially as companies may break criminal laws. A criminal case involves a governmental decision—whether state or federal—to prosecute someone (named as a defendant) for violating society's laws. The law establishes a moral minimum and does so especially in the area of criminal laws; if you break a criminal law, you can lose your freedom (in jail), your property (a fine), or your life (if you are convicted of a capital offense). In a civil action, you would not be sent to prison; in the worst case, you can lose property (usually money or other assets), such as when Ford Motor Company lost a personal injury case and the judge awarded $295 million to the plaintiffs or when Pennzoil won a $10.54 billion verdict against Texaco (see Chapter 7).

Some of the basic differences between civil law and criminal law cases are illustrated in Table 1.3.1.

Table 1.3.1: Differences between Civil and Criminal Cases

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

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

Substance versus Procedure

Many rules and regulations in law are substantive, and others are procedural. We are used to seeing laws as substantive; that is, there is some rule of conduct or behavior that is called for or some action that is proscribed (prohibited). The substantive rules tell us how to act with one another and with the government. For example, all of the following are substantive rules of law and provide a kind of command or direction to citizens:

- Drive not more than fifty-five miles per hour where that speed limit is posted.
- Do not conspire to fix prices with competitors in the US market.
- Do not falsely represent the curative effects of your over-the-counter herbal remedy.
- Do not drive your motor vehicle through an intersection while a red traffic signal faces the direction you are coming from.
- Do not discriminate against job applicants or employees on the basis of their race, sex, religion, or national origin.
- Do not discharge certain pollutants into the river without first getting a discharge permit.

In contrast, procedural laws are the rules of courts and administrative agencies. They tell us how to proceed if there is a substantive-law problem. For example, if you drive fifty-three miles per hour in a forty mile-per-hour zone on Main Street on a Saturday night and get a ticket, you have broken a substantive rule of law (the posted speed limit). Just how and what gets decided in court is a matter of procedural law. Is the police officer's word final, or do you get your say before a judge? If so, who goes first, you or the officer? Do you have the right to be represented by legal counsel? Does the hearing or trial have to take place within a certain time period? A week? A month? How long can the state take to bring its case? What kinds of evidence will be relevant? Radar? (Does it matter what kind of training the officer has had on the radar device? Whether the radar device had been tested adequately?) The officer's personal observation? (What kind of training has he had, how is he qualified to judge the speed of a car, and other questions arise.) What if you unwisely bragged to a friend at a party recently that you went a hundred miles an hour on Main Street five years ago at half past three on a Tuesday morning? (If the prosecutor knows of this and the "friend" is willing to testify, is it relevant to the charge of fifty-three in a forty-mile-per-hour zone?)

In the United States, all state procedural laws must be fair, since the due process clause of the Fourteenth Amendment directs that no state shall deprive any citizen of “life, liberty, or property,” without due process of law. (The $200 fine plus court costs is designed to deprive you of property, that is, money, if you violate the speed limit.) Federal laws must also be fair, because the Fifth Amendment to the US Constitution has the exact same due process language as the Fourteenth Amendment. This suggests that some laws are more powerful or important than others, which is true. The next section looks at various types of positive law and their relative importance.

Key Takeaway

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

Exercises

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

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1.4: Sources of Law and Their Priority

Learning Objectives

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

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

Sources of Law

In the United States today, there are numerous sources of law. The main ones are (1) constitutions—both state and federal, (2) statutes and agency regulations, and (3) judicial decisions. In addition, chief executives (the president and the various governors) can issue executive orders that have the effect of law.

In international legal systems, sources of law include treaties (agreements between states or countries) and what is known as customary international law (usually consisting of judicial decisions from national court systems where parties from two or more nations are in a dispute).

As you might expect, these laws sometimes conflict: a state law may conflict with a federal law, or a federal law might be contrary to an international obligation. One nation's law may provide one substantive rule, while another nation's law may provide a different, somewhat contrary rule to apply. Not all laws, in other words, are created equal. To understand which laws have priority, it is essential to understand the relationships between the various kinds of law.

Constitutions

Constitutions are the foundation for a state or nation's other laws, providing the country's legislative, executive, and judicial framework. Among the nations of the world, the United States has the oldest constitution still in use. It is difficult to amend, which is why there have only been seventeen amendments following the first ten in 1789; two-thirds of the House and Senate must pass amendments, and three-fourths of the states must approve them.

The nation's states also have constitutions. Along with providing for legislative, executive, and judicial functions, state constitutions prescribe various rights of citizens. These rights may be different from, and in addition to, rights granted by the US Constitution. Like statutes and judicial decisions, a constitution's specific provisions can provide people with a "cause of action" on which to base a lawsuit (see Section 1.4.3 "Causes of Action, Precedent, and " on "causes of action"). For example, California's constitution provides that the citizens of that state have a right of privacy. This has been used to assert claims against businesses that invade an employee's right of privacy or suppress speech on private commercial property. In the case of Virginia Rulon-Miller, her employer, International Business Machines (IBM), told her to stop dating a former colleague who went to work for a competitor. When she refused, IBM terminated her, and a jury fined the company for $300,000 in damages. As the California court noted, "While an employee sacrifices some privacy rights when he enters the workplace, the employee's privacy expectations must be balanced against the employer's interests.…[T]he point here is that privacy, like the other unalienable rights listed first in our Constitution…is unquestionably a fundamental interest of our society." (*Rulon-Miller v. International Business Machines Corp.*, 162 Cal. App.3d 241, 255 (1984).)

Statutes and Treaties in Congress

In Washington, DC, the federal legislature is known as Congress and has both a House of Representatives and a Senate. The House is composed of representatives elected every two years from various districts in each state. These districts are established by Congress according to population as determined every ten years by the census, a process required by the Constitution. Each state has at least one district; the most populous state (California) has fifty-two districts. In the Senate, there are two senators from each state, regardless of the state's population. Thus Delaware has two senators and California has two senators, even though California

has far more people. Effectively, less than 20 percent of the nation's population can send fifty senators to Washington. Many consider this result to be antidemocratic.

Each Congressional legislative body has committees for various purposes. In these committees, proposed bills are discussed, hearings are sometimes held, and bills are either reported out (brought to the floor for a vote) or killed in committee. If a bill is reported out, it may be passed by majority vote. Because of the procedural differences between the House and the Senate, bills that have the same language when proposed in both houses are apt to be different after approval by each body. A conference committee will then be held to try to match the two versions. If the two versions differ widely enough, reconciliation of the two differing versions into one acceptable to both chambers (House and Senate) is more difficult.

If the House and Senate can agree on identical language, the reconciled bill will be sent to the president for signature or veto. The Constitution prescribes that the president will have veto power over any legislation. But the two bodies can override a presidential veto with a two-thirds vote in each chamber.

In the case of treaties, the Constitution specifies that only the Senate must ratify them. When the Senate ratifies a treaty, it becomes part of federal law, with the same weight and effect as a statute passed by the entire Congress. The statutes of Congress are collected in codified form in the US Code.

Delegating Legislative Powers: Rules by Administrative Agencies

Congress has found it necessary and useful to create government agencies to administer various laws (see Chapter 5). The Constitution does not expressly provide for administrative agencies, but the US Supreme Court has upheld the delegation of power to create federal agencies.

Examples of administrative agencies would include the Occupational Safety and Health Administration (OSHA), the Environmental Protection Agency (EPA), and the Federal Trade Commission (FTC).

It is important to note that Congress does not have unlimited authority to delegate its lawmaking powers to an agency. It must delegate its authority with some guidelines for the agency and cannot altogether avoid its constitutional responsibilities (see Chapter 5).

Agencies propose rules in the Federal Register, published each working day of the year. Rules that are formally adopted are published in the *Code of Federal Regulations*, or CFR, available online at www.access.gpo.gov/nara/cfr/cfr-table-search.html.

State Statutes and Agencies: Other Codified Law

Statutes are passed by legislatures and provide general rules for society. States have legislatures (sometimes called assemblies), which are usually made up of both a senate and a house of representatives. Like the federal government, state legislatures will agree on the provisions of a bill, which is then sent to the governor (acting like the president for that state) for signature. Like the president, governors often have a veto power. The process of creating and amending, or changing, laws is filled with political negotiation and compromise.

On a more local level, counties and municipal corporations or townships may be authorized under a state's constitution to create or adopt ordinances. Examples of ordinances include local building codes, zoning laws, and misdemeanors or infractions such as skateboarding or jaywalking. Most of the more purported unusual laws that are in the news from time to time are local ordinances, but many of those stories are better characterized as urban legends than reports of actual laws.

Judicial Decisions: The Common Law

Common law consists of decisions by courts (judicial decisions) that do not involve interpretation of statutes, regulations, treaties, or the Constitution. Courts make such interpretations, but many cases are decided where there is no statutory or other codified law or regulation to be interpreted. For example, a state court deciding what kinds of witnesses are required for a valid will in the absence of a rule (from a statute) is making common law.

United States law comes primarily from the tradition of English common law. By the time England's American colonies revolted in 1776, English common-law traditions were well established in the colonial courts. English common law was a system that gave written judicial decisions the force of law throughout the country. Thus if an English court delivered an opinion as to what constituted the common-law crime of burglary, other courts would stick to that decision, so that a common body of law developed

throughout the country. Common law is essentially shorthand for the notion that a common body of law, based on past written decisions, is desirable and necessary.

In England and in the laws of the original thirteen states, common-law decisions defined crimes such as arson, burglary, homicide, and robbery. As time went on, US state legislatures either adopted or modified common-law definitions of most crimes by putting them in the form of codes or statutes. This legislative ability—to modify or change common law into judicial law—points to an important phenomenon: the priority of statutory law over common law. As we will see in the next section, constitutional law will have priority over statutory law.

Priority of Laws

The Constitution as Preemptive Force in US Law

The US Constitution takes precedence over all statutes and judicial decisions that are inconsistent. For example, if Michigan were to decide legislatively that students cannot speak ill of professors in state-sponsored universities, that law would be void, since it is inconsistent with the state's obligation under the First Amendment to protect free speech. Or if the Michigan courts were to allow a professor to bring a lawsuit against a student who had said something about him that was derogatory but not defamatory, the state's judicial system would not be acting according to the First Amendment. (As we will see in Chapter 7, free speech has its limits; defamation was a cause of action at the time the First Amendment was added to the Constitution, and it has been understood that the free speech rights in the First Amendment did not negate existing common law.)

Statutes and Cases

Statutes generally have priority, or take precedence, over case law (judicial decisions). Under common-law judicial decisions, employers could hire young children for difficult work, offer any wage they wanted, and not pay overtime work at a higher rate. But various statutes changed that. For example, the federal Fair Labor Standards Act (1938) forbid the use of oppressive child labor and established a minimum pay wage and overtime pay rules.

Treaties as Statutes: The "Last in Time" Rule

A treaty or convention is considered of equal standing to a statute. Thus when Congress ratified the North American Free Trade Agreement (NAFTA), any judicial decisions or previous statutes that were inconsistent—such as quotas or limitations on imports from Mexico that were opposite to NAFTA commitments—would no longer be valid. Similarly, US treaty obligations under the General Agreement on Tariffs and Trade (GATT) and obligations made later through the World Trade Organization (WTO) would override previous federal or state statutes.

One example of treaty obligations overriding, or taking priority over, federal statutes was the tuna-dolphin dispute between the United States and Mexico. The Marine Mammal Protection Act amendments in 1988 spelled out certain protections for dolphins in the Eastern Tropical Pacific, and the United States began refusing to allow the importation of tuna that were caught using "dolphin-unfriendly" methods (such as purse seining). This was challenged at a GATT dispute panel in Switzerland, and the United States lost. The discussion continued at the WTO under its dispute resolution process. In short, US environmental statutes can be ruled contrary to US treaty obligations.

Under most treaties, the United States can withdraw, or take back, any voluntary limitation on its sovereignty; participation in treaties is entirely elective. That is, the United States may "unbind" itself whenever it chooses. But for practical purposes, some limitations on sovereignty may be good for the nation. The argument goes something like this: if free trade in general helps the United States, then it makes some sense to be part of a system that promotes free trade; and despite some temporary setbacks, the WTO decision process will (it is hoped) provide far more benefits than losses in the long run. This argument invokes utilitarian theory (that the best policy does the greatest good overall for society) and David Ricardo's theory of comparative advantage.

Ultimately, whether the United States remains a supporter of free trade and continues to participate as a leader in the WTO will depend upon citizens electing leaders who support the process. Had Ross Perot been elected in 1992, for example, NAFTA would have been politically (and legally) dead during his term of office.

Causes of Action, Precedent, and *Stare Decisis*

No matter how wrong someone's actions may seem to you, the only wrongs you can right in a court are those that can be tied to one or more causes of action. Positive law is full of cases, treaties, statutes, regulations, and constitutional provisions that can be made into a cause of action. If you have an agreement with Harold Hill that he will purchase seventy-six trombones from you and he fails to pay for them after you deliver, you will probably feel wronged, but a court will only act favorably on your complaint if you can show that his behavior gives you a cause of action based on some part of your state's contract law. This case would give you a cause of action under the law of most states; unless Harold Hill had some legal excuse recognized by the applicable state's contract law—such as his legal incompetence, his being less than eighteen years of age, his being drunk at the time the agreement was made, or his claim that the instruments were trumpets rather than trombones or that they were delivered too late to be of use to him—you could expect to recover some compensation for his breaching of your agreement with him.

An old saying in the law is that the law does not deal in trifles, or unimportant issues (in Latin, *de minimis non curat lex*). Not every wrong you may suffer in life will be a cause to bring a court action. If you are stood up for a Saturday night date and feel embarrassed or humiliated, you cannot recover anything in a court of law in the United States, as there is no cause of action (no basis in the positive law) that you can use in your complaint. If you are engaged to be married and your spouse-to-be bolts from the wedding ceremony, there are some states that do provide a legal basis on which to bring a lawsuit. "Breach of promise to marry" is recognized in several states, but most states have abolished this cause of action, either by judicial decision or by legislation. Whether a runaway spouse gives rise to a valid cause of action in the courts depends on whether the state courts still recognize and enforce this now-disappearing cause of action.

Your cause of action is thus based on existing laws, including decided cases. How closely your case "fits" with a prior decided case raises the question of precedent.

As noted earlier in this chapter, the English common-law tradition placed great emphasis on precedent and what is called *stare decisis*. A court considering one case would feel obliged to decide that case in a way similar to previously decided cases. Written decisions of the most important cases had been spread throughout England (the common "realm"), and judges hoped to establish a somewhat predictable, consistent group of decisions.

The English legislature (Parliament) was not in the practice of establishing detailed statutes on crimes, torts, contracts, or property. Thus definitions and rules were left primarily to the courts. By their nature, courts could only decide one case at a time, but in doing so they would articulate holdings, or general rules, that would apply to later cases.

Suppose that one court had to decide whether an employer could fire an employee for no reason at all. Suppose that there were no statutes that applied to the facts: there was no contract between the employer and the employee, but the employee had worked for the employer for many years, and now a younger person was replacing him. The court, with no past guidelines, would have to decide whether the employee had stated a "cause of action" against the employer. If the court decided that the case was not legally actionable, it would dismiss the action. Future courts would then treat similar cases in a similar way. In the process, the court might make a holding that employers could fire employees for any reason or for no reason. This rule could be applied in the future should similar cases come up.

But suppose that an employer fired an employee for not committing perjury (lying on the witness stand in a court proceeding); the employer wanted the employee to cover up the company's criminal or unethical act. Suppose that, as in earlier cases, there were no applicable statutes and no contract of employment. Courts relying on a holding or precedent that "employers may fire employees for any reason or no reason" might rule against an employee seeking compensation for being fired for telling the truth on the witness stand. Or it might make an exception to the general rule, such as, "Employers may generally discharge employees for any reason or for no reason without incurring legal liability; however, employers will incur legal liability for firing an employee who refuses to lie on behalf of the employer in a court proceeding."

In each case (the general rule and its exception), the common-law tradition calls for the court to explain the reasons for its ruling. In the case of the general rule, "freedom of choice" might be the major reason. In the case of the perjury exception, the efficiency of the judicial system and the requirements of citizenship might be used as reasons. Because the court's "reasons" will be persuasive to some and not to others, there is inevitably a degree of subjectivity to judicial opinions. That is, reasonable people will disagree as to the persuasiveness of the reasoning a court may offer for its decision.

Written judicial opinions are thus a good playing field for developing critical thinking skills by identifying the issue in a case and examining the reasons for the court's previous decision(s), or holding. What *has* the court actually decided, and why? Remember that a court, especially the US Supreme Court, is not only deciding one particular case but also setting down guidelines (in its holdings) for federal and state courts that encounter similar issues. Note that court cases often raise a variety of issues or questions to be resolved, and judges (and attorneys) will differ as to what the real issue in a case is. A holding is the court's complete answer to an issue that is critical to deciding the case and thus gives guidance to the meaning of the case as a precedent for future cases.

Beyond the decision of the court, it is in looking at the court's *reasoning* that you are most likely to understand what facts have been most significant to the court and what theories (schools of legal thought) each trial or appellate judge believes in. Because judges do not always agree on first principles (i.e., they subscribe to different schools of legal thought), there are many divided opinions in appellate opinions and in each US Supreme Court term.

Key Takeaway

There are different sources of law in the US legal system. The US Constitution is foundational; US statutory and common law cannot be inconsistent with its provisions. Congress creates statutory law (with the signature of the president), and courts will interpret constitutional law and statutory law. Where there is neither constitutional law nor statutory law, the courts function in the realm of common law. The same is true of law within the fifty states, each of which also has a constitution, or foundational law.

Both the federal government and the states have created administrative agencies. An agency only has the power that the legislature gives it. Within the scope of that power, an agency will often create regulations (see Chapter 5), which have the same force and effect as statutes. Treaties are never negotiated and concluded by states, as the federal government has exclusive authority over relations with other nation-states. A treaty, once ratified by the Senate, has the same force and effect as a statute passed by Congress and signed into law by the president.

Constitutions, statutes, regulations, treaties, and court decisions can provide a legal basis in the positive law. You may believe you have been wronged, but for you to have a right that is enforceable in court, you must have something in the positive law that you can point to that will support a cause of action against your chosen defendant.

Exercises

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

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1.5: Legal and Political Systems of the World

Learning Objectives

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

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

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

Comparing Common-Law Systems with Other Legal Systems

The common-law tradition is unique to England, the United States, and former colonies of the British Empire. Although there are differences among common-law systems (e.g., most nations do not permit their judiciaries to declare legislative acts unconstitutional; some nations use the jury less frequently), all of them recognize the use of precedent in judicial cases, and none of them relies on the comprehensive, legislative codes that are prevalent in civil-law systems.

Civil-Law Systems

The main alternative to the common-law legal system was developed in Europe and is based in Roman and Napoleonic law. A civil-law or code-law system is one where all the legal rules are in one or more comprehensive legislative enactments. During Napoleon's reign, a comprehensive book of laws—a code—was developed for all of France. The code covered criminal law, criminal procedure, noncriminal law and procedure, and commercial law. The rules of the code are still used today in France and in other continental European legal systems. The code is used to resolve particular cases, usually by judges without a jury. Moreover, the judges are not required to follow the decisions of other courts in similar cases. As George Cameron of the University of Michigan has noted, "The law is in the code, not in the cases." He goes on to note, "Where several cases all have interpreted a provision in a particular way, the French courts may feel bound to reach the same result in future cases, under the doctrine of *jurisprudence constante*. The major agency for growth and change, however, is the legislature, not the courts."

Civil-law systems are used throughout Europe as well as in Central and South America. Some nations in Asia and Africa have also adopted codes based on European civil law. Germany, Holland, Spain, France, and Portugal all had colonies outside of Europe, and many of these colonies adopted the legal practices that were imposed on them by colonial rule, much like the original thirteen states of the United States, which adopted English common-law practices.

One source of possible confusion at this point is that we have already referred to US civil law in contrast to criminal law. But the European civil law covers both civil and criminal law.

There are also legal systems that differ significantly from the common-law and civil-law systems. The communist and socialist legal systems that remain (e.g., in Cuba and North Korea) operate on very different assumptions than those of either English common law or European civil law. Islamic and other religiously-based systems of law bring different values and assumptions to social and commercial relations.

Key Takeaway

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

Exercises

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

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1.6: Summary and Exercises

Summary

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

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

Exercises

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

    a. The state statute conflicts with the common law of that state.
    b. A federal statute conflicts with the US Constitution.
    c. A common-law decision in one state conflicts with the US Constitution.
    d. A federal statute conflicts with a state constitution.

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CHAPTER OVERVIEW

2: Corporate Social Responsibility and Business Ethics

Learning Objectives

After reading this chapter, you should understand the following:

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

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

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

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

2.1: What Is Ethics?
2.2: Major Ethical Perspectives
2.3: An Ethical Decision Model
2.4: Corporations and Corporate Governance
2.5: Summary and Exercises

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2.1: What Is Ethics?

Learning Objectives

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

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

Most of those who write about ethics do not make a clear distinction between ethics and morality. The question of what is "right" or "morally correct" or "ethically correct" or "morally desirable" in any situation is variously phrased, but all of the words and phrases are after the same thing: what act is "better" in a moral or ethical sense than some other act? People sometimes speak of morality as something personal but view ethics as having wider social implications. Others see morality as the subject of a field of study, that field being ethics. Ethics would be morality as applied to any number of subjects, including journalistic ethics, business ethics, or the ethics of professionals such as doctors, attorneys, and accountants. We will venture a definition of *ethics*, but for our purposes, *ethics* and *morality* will be used as equivalent terms.

People often speak about the ethics or morality of individuals and also about the morality or ethics of corporations and nations. There are clearly differences in the kind of moral responsibility that we can fairly ascribe to corporations and nations; we tend to see individuals as having a soul, or at least a conscience, but there is no general agreement that nations or corporations have either. Still, our ordinary use of language does point to something significant: if we say that some nations are "evil" and others are "corrupt," then we make moral judgments about the quality of actions undertaken by the governments or people of that nation. For example, if North Korea is characterized by the US president as part of an "axis of evil," or if we conclude that Theranos or FTX acted "unethically" in certain respects, then we are making judgments that their collective actions are morally deficient.

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

A word such as *good* can embrace ethical or moral values but also nonethical values. If I like Minh and try to convince you what a "good guy" he is, you may ask all sorts of questions: Is he good-looking? Well-off? Fun to be with? Humorous? Athletic? Smart? I could answer all of those questions with a yes, yet you would still not know any of his moral qualities. But if I said that he was honest, caring, forthright, and diligent, volunteered in local soup kitchens, or tithed to the church, many people would see Minh as having certain ethical or moral qualities. If I said that he keeps the Golden Rule as well as anyone I know, you could conclude that he is an ethical person. But if I said that he is "always in control" or "always at the top of his game," you would probably not make inferences or assumptions about his character or ethics.

There are three key points here:

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

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

Before talking about how ethics relates to law, we can conclude that ethics is the study of morality—"right" and "wrong"—in the context of everyday life, organizational behaviors, and even how society operates and is governed.

How Do Law and Ethics Differ?

There is a difference between legal compliance and moral excellence. Few would choose a professional service, health care or otherwise, because the provider had a record of perfect legal compliance, or always following the letter of the law. There are many professional ethics codes, primarily because people realize that law prescribes only a minimum of morality and does not provide purpose or goals that can mean excellent service to customers, clients, or patients.

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

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

- Individuals and organizations have reputations. (For an individual, moral reputation is most often tied to others’ perceptions of his or her character: is the individual honest, diligent, reliable, fair, and caring? The reputation of an organization is built on the goodwill that suppliers, customers, the community, and employees feel toward it. Although an organization is not a person in the usual sense, the goodwill that people feel about the organization is based on their perception of its better qualities by a variety of stakeholders: customers or clients, suppliers, investors, employees, government officials).
- The goodwill of an organization is to a great extent based on the actions it takes and on whether the actions are favorably viewed. (This goodwill is usually specifically counted in the sale of a business as an asset that the buyer pays for. While it is difficult to place a monetary value on goodwill, a firm’s good reputation will generally call for a higher evaluation in the final accounting before the sale. Legal troubles or a reputation for having legal troubles will only lessen the price for a business and will even lessen the value of the company’s stock as bad legal news comes to the public’s attention.)

Another reason to think about ethics in connection with law is that the laws themselves are meant to express some moral view. If there are legal prohibitions against cheating the Medicare program, it is because people (legislators or their agents) have collectively decided that cheating Medicare is wrong. If there are legal prohibitions against assisting someone to commit suicide, it is because there has been a group decision that doing so is immoral. Thus the law provides some important cues as to what society regards as right or wrong.

Finally, important policy issues that face society are often resolved through law, but it is important to understand the moral perspectives that underlie public debate—as, for example, in the continuing controversies over stem-cell research, medical use of marijuana, and abortion. Some ethical perspectives focus on rights, some on social utility, some on virtue or character, and some on social justice. People consciously (or, more often, unconsciously) adopt one or more of these perspectives, and even if they completely agree on the facts with an opponent, they will not change their views. Fundamentally, the difference comes down to incompatible moral perspectives, a clash of basic values. These are hot-button issues because society is divided, not so much over facts, but over basic values. Understanding the varied moral perspectives and values in public policy debates is a clarifying benefit in following or participating in these important discussions.

Why Should an Individual or a Business Entity Be Ethical?

The usual answer is that good ethics is good business. In the long run, businesses that pay attention to ethics as well as law do better; they are viewed more favorably by customers. But this is a difficult claim to measure scientifically, because “the long run” is an indistinct period of time and because there are as yet no generally accepted criteria by which ethical excellence can be measured. In addition, life is still lived in the short run, and there are many occasions when something short of perfect conduct is a lot more profitable.

Some years ago, Royal Dutch/Shell (one of the world’s largest companies) found that it was in deep trouble with the public for its apparent carelessness with the environment and human rights. Consumers were boycotting and investors were getting frightened, so the company took a long, hard look at its ethic of short-term profit maximization. Since then, changes have been made. The CEO told one group of business ethicists that the uproar had taken them by surprise; they thought they had done everything right, but it seemed there was a “ghost in the machine.” That ghost was consumers, non-governmental organizations (NGOs), and the media, all of whom objected to the company’s seeming lack of moral sensitivity.

The market does respond to unethical behavior. In Section 2.4, you will read about the Sears Auto Center case. The loss of goodwill toward Sears Auto Center was real, even though the total amount of money lost could not be clearly accounted for. Ultimately, customers who lost trust in the company never returned and the company went out of business.

The Arthur Andersen story is even more dramatic. A major accounting firm, Andersen worked closely with Enron in hiding its various losses through creative accounting measures. Suspiciously, Andersen's Houston office also did some shredding around the clock, appearing to cover up what it was doing for Enron. A criminal case based on this shredding resulted in a conviction, later overturned by the Supreme Court. But it was too late. Even before the conviction, many clients had found other accounting firms that were not under suspicion, and the Supreme Court's reversal came too late to save the company. Even without the conviction, Andersen would have lost significant market share.

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

Maximizing profits while being legally compliant is not a very inspiring goal for a business. People in an organization need some quality or excellence to strive for. By focusing on pushing the edge of what is legal, by looking for loopholes in the law that would help create short-term financial gain, companies have often learned that in the long term they are not actually satisfying the market, the shareholders, the suppliers, or the community generally.

Key Takeaway

Legal compliance is not the same as acting ethically. Your reputation, individually or corporately, depends on how others regard your actions. Goodwill is hard to measure or quantify, but it is real nonetheless and can best be protected by acting ethically.

Exercises

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

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2.2: Major Ethical Perspectives

Learning Objectives

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

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

There are several well-respected ways of looking at ethical issues. Some of them have been around for centuries. It is important to know that many who think a lot about business and ethics have deeply held beliefs about which perspective is best. Others would recommend considering ethical problems from a variety of different perspectives. Here, we take a brief look at (1) utilitarianism, (2) deontology, (3) social justice and social contract theory, and (4) virtue theory. We are leaving out some important perspectives, such as general theories of justice and "rights" and feminist thought about ethics and patriarchy.

Utilitarianism

Utilitarianism is a prominent perspective on ethics, one that is well aligned with economics and the free-market outlook that has come to dominate much current thinking about business, management, and economics. Jeremy Bentham is often considered the founder of utilitarianism, though John Stuart Mill (who wrote *On Liberty* and *Utilitarianism*) and others promoted it as a guide to what is good. Utilitarianism emphasizes not rules but results. An action (or set of actions) is generally deemed good or right if it maximizes happiness or pleasure throughout society. Originally intended as a guide for legislators charged with seeking the greatest good for society, the utilitarian outlook may also be practiced individually and by corporations.

Bentham believed that the most promising way to obtain agreement on the best policies for a society would be to look at the various policies a legislature could pass and compare the good and bad consequences of each. The right course of action from an ethical point of view would be to choose the policy that would produce the greatest amount of utility, or usefulness. In brief, the utilitarian principle holds that an action is right if and only if the sum of utilities produced by that action is greater than the sum of utilities from any other possible act.

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

Notice that the emphasis is on finding the best possible results and that the assumption is that we can measure the utilities involved. (This turns out to be more difficult than you might think.) Notice also that "the sum total of utilities" clearly implies that in doing utilitarian analysis, we cannot be satisfied if an act or set of acts provides the greatest utility to us as individuals or to a particular corporation; the test is, instead, whether it provides the greatest utility to society as a whole. Notice that the theory does not tell us what kinds of utilities may be better than others or how much better a good today is compared with a good a year from today.

Whatever its difficulties, utilitarian thinking is alive and well in US law and business. It is found in such diverse places as cost-benefit analysis in administrative and regulatory rules and calculations, environmental impact studies, the majority vote, product comparisons for consumer information, marketing studies, tax laws, and strategic planning. In management, people will often employ a form of utility reasoning by projecting costs and benefits for plan X versus plan Y. But the issue in most of these cost-benefit analyses is usually (1) put exclusively in terms of money and (2) directed to the benefit of the person or organization doing the analysis and not to the benefit of society as a whole.

An individual or a company that consistently uses the test "What's the greatest good for me or the company?" is not following the utilitarian test of the greatest good overall. Another common failing is to see only one or two options that seem reasonable. The following are some frequent mistakes that people make in applying what they think are utilitarian principles in justifying their chosen course of action:

1. Failing to come up with lots of options that seem reasonable and then choosing the one that has the greatest benefit for the greatest number. Often, a decision maker seizes on one or two alternatives without thinking carefully about other courses of action. If the alternative does more good than harm, the decision maker assumes it's ethically okay.

2. Assuming that the greatest good for you or your company is in fact the greatest good for all—that is, looking at situations subjectively or with your own interests primarily in mind.
3. Underestimating the costs of a certain decision to you or your company. The now-classic Ford Pinto case demonstrates how Ford Motor Company executives drastically underestimated the legal costs of not correcting a feature on their Pinto models that they knew could cause death or injury. General Motors was often taken to task by juries that came to understand that the company would not recall or repair known and dangerous defects because it seemed more profitable not to. Toyota and Volkswagen learned the same lessons in later cases.
4. Underestimating the cost or harm of a certain decision to someone else or some other group of people.
5. Favoring short-term benefits, even though the long-term costs are greater.
6. Assuming that all values can be reduced to money. In comparing the risks to human health or safety against, say, the risks of job or profit losses, cost-benefit analyses will often try to compare apples to oranges and put arbitrary numerical values on human health and safety.

Rules and Duty: Deontology

In contrast to the utilitarian perspective, the deontological view presented in the writings of Immanuel Kant purports that having a moral intent and following the right rules is a better path to ethical conduct than achieving the right results. A deontologist like Kant is likely to believe that ethical action arises from doing one's duty and that duties are defined by rational thought. Duties, according to Kant, are not specific to particular kinds of human beings but are owed universally to all human beings. Kant therefore uses "universalizing" as a form of rational thought that assumes the inherent equality of all human beings. It considers all humans as equal, not in the physical, social, or economic sense, but equal before God, whether they are male, female, Pygmy, Eskimoan, Islamic, Christian, gay, straight, healthy, sick, young, or old.

For Kantian thinkers, this basic principle of equality means that we should be able to universalize any particular law or action to determine whether it is ethical. For example, if you were to consider misrepresenting yourself on a resume for a particular job you really wanted and you were convinced that doing so would get you that job, you might be very tempted to do so. (What harm would it be? you might ask yourself. When I have the job, I can prove that I was perfect for it, and no one is hurt, while both the employer and I are clearly better off as a result!) Kantian ethicists would answer that your chosen course of action should be a universal one—a course of action that would be good for all persons at all times. There are two requirements for a rule of action to be universal: consistency and reversibility. Consider reversibility: if you make a decision as though you didn't know what role or position you would have after the decision, you would more likely make an impartial one—you would more likely choose a course of action that would be most fair to all concerned, not just you. Again, deontology requires that we put duty first, act rationally, and give moral weight to the inherent equality of all human beings.

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

The second requirement for an action to be universal is the search for consistency. This is more abstract. A deontologist would say that since you know you are telling a lie, you must be willing to say that lying, as a general, universal phenomenon, is acceptable. But if everyone lied, then there would be no point to lying, since no one would believe anyone. It is only because honesty works well for society as a whole and is generally practiced that lying even becomes possible! That is, lying cannot be universalized, for it depends on the preexistence of honesty.

Similar demonstrations can be made for actions such as polluting, breaking promises, and committing most crimes, including rape, murder, and theft. But these are the easy cases for Kantian thinkers. In the gray areas of life as it is lived, the consistency test is often difficult to apply. If breaking a promise would save a life, then Kantian thought becomes difficult to apply. If some amount of pollution can allow employment and the harm is minimal or distant, Kantian thinking is not all that helpful. Finally, we should note that the well-known Golden Rule, "Do unto others as you would have them do unto you," emphasizes the easier of the two universalizing requirements: practicing reversibility ("How would I like it if someone did this to me?").

Social Justice Theory and Social Contract Theory

Social justice theorists worry about "distributive justice"—that is, what is the fair way to distribute goods among a group of people? Marxist thought emphasizes that members of society should be given goods according to their needs. But this redistribution would require a governing power to decide who gets what and when. Capitalist thought takes a different approach, rejecting any giving that is not voluntary. Certain economists, such as the late Milton Friedman (see the sidebar in Section 2.4) also reject the notion that a corporation has a duty to give to unmet needs in society, believing that the government should play that role. Even the most dedicated free-market capitalist will often admit the need for some government and some forms of welfare—Social Security, Medicare, assistance to flood-stricken areas—along with some public goods (such as defense, education, highways, parks, and support of key industries affecting national security).

People who do not see the need for public goods (including laws, court systems, and the government goods and services just cited) often question why there needs to be a government at all. One response might be, "Without government, there would be no corporations." Thomas Hobbes believed that people in a "state of nature" would rationally choose to have some form of government. He called this the social contract, where people give up certain rights to government in exchange for security and common benefits. In your own lives and in this course, you will see an ongoing balancing act between human desires for freedom and human desires for order; it is an ancient tension. Some commentators also see a kind of social contract between corporations and society; in exchange for perpetual duration and limited liability, the corporation has some corresponding duties toward society. Also, if a corporation is legally a "person," as the Supreme Court reaffirmed in 2010, then some would argue that if this corporate person commits three felonies, it should be locked up for life and its corporate charter revoked!

Modern social contract theorists, such as Thomas Donaldson and Thomas Dunfee (*Ties that Bind*, 1999), observe that various communities, not just nations, make rules for the common good. Your college or school is a community, and there are communities within the school (fraternities, sororities, the folks behind the counter at the circulation desk, the people who work together at the university radio station, the sports teams, the faculty, the students generally, the gay and lesbian alliance) that have rules, norms, or standards that people can buy into or not. If not, they can exit from that community, just as we are free (though not without cost) to reject US citizenship and take up residence in another country.

Donaldson and Dunfee's integrative social contracts theory stresses the importance of studying the rules of smaller communities along with the larger social contracts made in states (such as Colorado or California) and nation-states (such as the United States or Germany). Our Constitution can be seen as a fundamental social contract.

It is important to realize that a social contract can be changed by the participants in a community, just as the US Constitution can be amended. Social contract theory is thus dynamic—it allows for structural and organic changes. Ideally, the social contract struck by citizens and the government allows for certain fundamental rights such as those we enjoy in the United States, but it need not. People can give up freedom-oriented rights (such as the right of free speech or the right to be free of unreasonable searches and seizures) to secure order (freedom from fear, freedom from terrorism). For example, many citizens in Russia now miss the days when the Kremlin was all powerful; there was less crime and more equality and predictability to life in the Soviet Union, even if there was less freedom and people were equally poor.

Thus the rights that people have—in positive law—come from whatever social contract exists in the society. This view differs from that of the deontologists and that of the natural-law thinkers such as Gandhi, Jesus, or Martin Luther King Jr., who believed that rights come from God or, in less religious terms, from some transcendent moral order.

Another important movement in ethics and society is the communitarian outlook. Communitarians emphasize that rights carry with them corresponding duties; that is, there cannot be a right without a duty. Interested students may wish to explore the work of Amitai Etzioni. Etzioni was a founder of the Communitarian Network, which is a group of individuals who have come together to bolster the moral, social, and political environment. It claims to be nonsectarian, nonpartisan, and international in scope.

The relationship between rights and duties—in both law and ethics—calls for some explanations:

1. If you have a right of free expression, the government has a duty to respect that right but can put reasonable limits on it. For example, you can legally say whatever you want about the US president, but you can't get away with threatening the president's life. Even if your criticisms are strong and insistent, you have the right (and our government has the duty to protect your right)

to speak freely. In Singapore during the 1990s, even indirect criticisms—mere hints—of the political leadership were enough to land you in jail or at least silence you with a libel suit.

2. Rights and duties exist not only between people and their governments but also between individuals. Your right to be free from physical assault is protected by the law in most states, and when someone walks up to you and punches you in the nose, your rights—as set forth in the positive law of your state—have been violated. Thus other people have a duty to respect your rights and to not punch you in the nose.
3. Your right in legal terms is only as good as your society's willingness to provide legal remedies through the courts and political institutions of society.

A distinction between basic rights and nonbasic rights may also be important. Basic rights may include such fundamental elements as food, water, shelter, and physical safety. Another distinction is between positive rights (the right to bear arms, the right to vote, the right of privacy) and negative rights (the right to be free from unreasonable searches and seizures, the right to be free of cruel or unusual punishments). Yet another is between economic or social rights (adequate food, work, and environment) and political or civic rights (the right to vote, the right to equal protection of the laws, the right to due process).

Aristotle and Virtue Theory

Virtue theory, or virtue ethics, has received increasing attention over the past twenty years, particularly in contrast to utilitarian and deontological approaches to ethics. Virtue theory emphasizes the value of virtuous qualities rather than formal rules or useful results. Aristotle is often recognized as the first philosopher to advocate the ethical value of certain qualities, or virtues, in a person's character. As LaRue Hosmer has noted, Aristotle saw the goal of human existence as the active, rational search for excellence, and excellence requires the personal virtues of honesty, truthfulness, courage, temperance, generosity, and high-mindedness. This pursuit is also termed "knowledge of the good" in Greek philosophy.LaRue Tone Hosmer, *Moral Leadership in Business* (Chicago: Irwin Professional Publishing, 1994), 72.

Aristotle believed that all activity was aimed at some goal or perceived good and that there must be some ranking that we do among those goals or goods. Happiness may be our ultimate goal, but what does that mean, exactly? Aristotle rejected wealth, pleasure, and fame and embraced reason as the distinguishing feature of humans, as opposed to other species. And since a human is a reasoning animal, happiness must be associated with reason. Thus happiness is living according to the active (rather than passive) use of reason. The use of reason leads to excellence, and so happiness can be defined as the active, rational pursuit of personal excellence, or virtue.

Aristotle named fourteen virtues: (1) courage, particularly in battle; (2) temperance, or moderation in eating and drinking; (3) liberality, or spending money well; (4) magnificence, or living well; (5) pride, or taking pleasure in accomplishments and stature; (6) high-mindedness, or concern with the noble rather than the petty; (7) unnamed virtue, which is halfway between ambition and total lack of effort; (8) gentleness, or concern for others; (9) truthfulness; (10) wit, or pleasure in group discussions; (11) friendliness, or pleasure in personal conduct; (12) modesty, or pleasure in personal conduct; (13) righteous indignation, or getting angry at the right things and in the right amounts; and (14) justice.

From a modern perspective, some of these virtues seem old-fashioned or even odd. Magnificence, for example, is not something we commonly speak of. Three issues emerge: (1) How do we know what a virtue is these days? (2) How useful is a list of agreed-upon virtues anyway? (3) What do virtues have to do with companies, particularly large ones where various groups and individuals may have little or no contact with other parts of the organization?

As to the third question, whether corporations can "have" virtues or values is a matter of lively debate. A corporation is obviously not the same as an individual. But there seems to be growing agreement that organizations do differ in their practices and that these practices are value driven. If all a company cares about is the bottom line, other values will diminish or disappear. Quite a few books have been written in the past twenty years that emphasize the need for businesses to define their values in order to be competitive in today's global economy.James O'Toole and Don Mayer, eds., *Good Business: Exercising Effective and Ethical Leadership* (London: Routledge, 2010).

As to the first two questions regarding virtues, a look at Michael Josephson's core values may prove helpful.

Josephson's Core Values Analysis and Decision Process

Michael Josephson, a noted American ethicist, believes that a current set of *core values* has been identified and that the values can be meaningfully applied to a variety of personal and corporate decisions.

To simplify, let's say that there are ethical and nonethical qualities among people in the United States. When you ask people what kinds of qualities they admire in others or in themselves, they may say wealth, power, fitness, sense of humor, good looks, intelligence, musical ability, or some other quality. They may also value honesty, caring, fairness, courage, perseverance, diligence, trustworthiness, or integrity. The qualities on the second list have something in common—they are distinctively ethical characteristics. That is, they are commonly seen as moral or ethical qualities, unlike the qualities on the first list. You can be, like the Athenian Alcibiades, brilliant but unprincipled, or, like some political leaders today, powerful but dishonest, or wealthy but uncaring. You can, in short, have a number of admirable qualities (brilliance, power, wealth) that are not per se virtuous. Just because Shante is rich or good-looking or has a good sense of humor does not mean that she is ethical. But if Shante is honest and caring (whether she is rich or poor, humorous or humorless), people are likely to see her as ethical.

Among the virtues, are any especially important? Studies from the Josephson Institute of Ethics in Marina del Rey, California, have identified six core values in our society, values that almost everyone agrees are important to them. When asked what values people hold dear, what values they wish to be known by, and what values they wish others would exhibit in their actions, six values consistently turn up: (1) trustworthiness, (2) respect, (3) responsibility, (4) fairness, (5) caring, and (6) citizenship.

Note that these values are distinctly ethical. While many of us may value wealth, good looks, and intelligence, having wealth, good looks, and intelligence does not automatically make us virtuous in our character and habits. But being more trustworthy (by being honest and by keeping promises) does make us more virtuous, as does staying true to the other five core values.

Notice also that these six core values share something in common with other ethical values that are less universally agreed upon. Many values taught in the family or in places of worship are not generally agreed on, practiced, or admired by all. Some families and individuals believe strongly in the virtue of saving money or in abstaining from alcohol or sex prior to marriage. Others clearly do not, or at least don't act on their beliefs. Moreover, it is possible to have and practice core ethical values even if you take on heavy debt, knock down several drinks a night, or have frequent premarital sex. Some would dispute this, saying that you can't really lead a virtuous life if you get into debt, drink heavily, or engage in premarital sex. But the point here is that since people do disagree in these areas, the ethical traits of thrift, temperance, and sexual abstinence do not have the unanimity of approval that the six core values do.

The importance of an individual's having these consistent qualities of character is well known. Often we remember the last bad thing a person did far more than any or all previous good acts. For example, Eliot Spitzer and Bob Menendez are more readily remembered by people for their last, worst acts than for any good they accomplished as public servants. As for a company, its good reputation also has an incalculable value that when lost takes a great deal of time and work to recover. Shell, Nike, and other companies have discovered that there is a market for morality, however difficult to measure, and that not paying attention to business ethics often comes at a serious price. In the past thirty years, the career of ethics and compliance officer has emerged, partly as a result of criminal proceedings against companies but also because major companies have found that reputations cannot be recovered retroactively but must be pursued proactively. For individuals, Aristotle emphasized the practice of virtue to the point where virtue becomes a habit. Companies are gradually learning the same lesson.

Key Takeaway

Throughout history, people have pondered what it means "to do what is right." Some of the main answers have come from the differing perspectives of utilitarian thought; duty-based, or deontological, thought; social contract theory; and virtue ethics.

Exercises

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

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

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

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

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

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2.3: An Ethical Decision Model

Learning Objectives

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

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

Josephson's Core Values Model

Once you recognize that there is a decision that involves ethical judgment, Michael Josephson would first have you ask as many questions as are necessary to get a full background on the relevant facts. Then, assuming you have all the needed information, the decision process is as follows:

1. Identify the stakeholders. That is, who are the potential gainers and losers in the various decisions that might be made here?
2. Identify several likely or reasonable decisions that could be made.
3. Consider which stakeholders gain or lose with each decision.
4. Determine which decision satisfies the greatest number of core values.
5. If there is no decision that satisfies the greatest number of core values, try to determine which decision delivers the greatest good to the various stakeholders.

It is often helpful to identify who (or what group) is the most important stakeholder, and why. In Milton Friedman's view, it will always be the shareholders. In the view of John Mackey, the former CEO of Whole Foods Market, the long-term viability and profitability of the organization may require that customers come first, or, at times, some other stakeholder group (see "Conscious Capitalism" in Section 2.4).

The Core Values

Here are the core values and their subcomponents as developed by the Josephson Institute of Ethics.

- **Trustworthiness:** *Be honest*—tell the truth, the whole truth, and nothing but the truth; be sincere, forthright; don't deceive, mislead, or be tricky with the truth; don't cheat or steal, and don't betray a trust. *Demonstrate integrity*—stand up for what you believe, walk the walk as well as talking the talk; be what you seem to be; show commitment and courage. *Be loyal*—stand by your family, friends, co-workers, community, and nation; be discreet with information that comes into your hands; don't spread rumors or engage in harmful gossip; don't violate your principles just to win friendship or approval; don't ask a friend to do something that is wrong. *Keep promises*—keep your word, honor your commitments, and pay your debts; return what you borrow.
- **Respect:** Judge people on their merits, not their appearance; be courteous, polite, appreciative, and accepting of differences; respect others' right to make decisions about their own lives; don't abuse, demean, mistreat anyone; don't use, manipulate, exploit, or take advantage of others.
- **Responsibility:** Be accountable—think about the consequences on yourself and others likely to be affected before you act; be reliable; perform your duties; take responsibility for the consequences of your choices; set a good example and don't make excuses or take credit for other people's work. Pursue excellence: Do your best, don't quit easily, persevere, be diligent, make all you do worthy of pride. Exercise self-restraint—be disciplined, know the difference between what you have a right to do and what is right to do.
- **Fairness:** Treat all people fairly, be open-minded; listen; consider opposing viewpoints; be consistent; use only appropriate considerations; don't let personal feelings improperly interfere with decisions; don't take unfair advantage of mistakes; don't take more than your fair share.
- **Caring:** Show you care about others through kindness, caring, sharing, compassion, and empathy; treat others the way you want to be treated; don't be selfish, mean, cruel, or insensitive to others' feelings.
- **Citizenship:** Play by the rules, obey laws; do your share, respect authority, stay informed, vote, protect your neighbors, pay your taxes; be charitable, help your community; protect the environment, conserve resources.

When individuals and organizations confront ethical problems, the core values decision model offered by Josephson generally works well (1) to clarify the gains and losses of the various stakeholders, which then raises ethical awareness on the part of the decision maker and (2) to provide a fairly reliable guide as to what the most ethical decision would be. In nine out of ten cases, step 5 in the decision process is not needed.

That said, it does not follow that students (or managers) would necessarily act in accord with the results of the core values decision process. There are many psychological pressures and organizational constraints that place limits on people both individually and in organizations. These pressures and constraints tend to compromise ideal or the most ethical solutions for individuals and for organizations. For a business, one essential problem is that ethics can cost the organization money or resources, at least in the short term. Doing the most ethical thing will often appear to be something that fails to maximize profits in the short term or that may seem pointless because if you or your organization acts ethically, others will not, and society will be no better off, anyway.

Key Takeaway

Having a step-by-step process to analyze difficult moral dilemmas is useful. One such process is offered here, based on the core values of trustworthiness, caring, respect, fairness, responsibility, and citizenship.

Exercises

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

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2.4: Corporations and Corporate Governance

Learning Objectives

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

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

Legal Organization of the Corporation

Figure 2.4.1, though somewhat oversimplified, shows the basic legal structure of a corporation under Delaware law and the laws of most other states in the United States. Shareholders elect directors, who then hire officers to manage the company. From this structure, some very basic realities follow. Because the directors of a corporation do not meet that often, it's possible for the officers hired (top management, or the "C-suite") to be selective of what the board knows about, and directors are not always ready and able to provide the oversight that the shareholders would like. Nor does the law require officers to be shareholders, so that officers' motivations may not align with the best interests of the company. This is the "agency problem" often discussed in corporate governance: how to get officers and other top management to align their own interests with those of the shareholders.

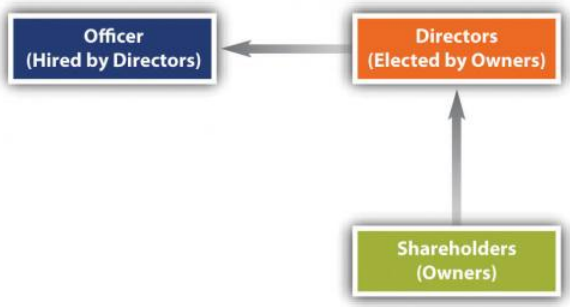


Figure 2.4.1: Corporate Legal Structure

For example, a CEO might trade insider information to the detriment of the company's shareholders. Even board members are susceptible to misalignment of interets; for example, board members might resist hostile takeover bids because they would likely lose their perks (short for *perquisites*) as directors, even though the tender offer would benefit stockholders. Among other attempted realignments, the use of stock options was an attempt to make managers more attentive to the value of company stock, but the law of unintended consequences was in full force; managers tweaked and managed earnings in the bubble of the 1990s bull market, and "managing by numbers" became an epidemic in corporations organized under US corporate law. The rights of shareholders can be bolstered by changes in state and federal law, and there have been some attempts to do that since the late 1990s. But as owners, shareholders have the ultimate power to replace nonperforming or underperforming directors, which usually results in changes at the C-suite level as well.

Shareholders and Stakeholders

There are two main views about what the corporation's duties are. The first view—maximizing profits—is the prevailing view among business managers and in business schools. This view largely follows the idea of Milton Friedman that the duty of a manager is to maximize return on investment to the owners. In essence, managers' legally prescribed duties are those that make their employment possible. In terms of the legal organization of the corporation, the shareholders elect directors who hire managers, who have legally prescribed duties toward both directors and shareholders. Those legally prescribed duties are a reflection of the fact that managers are managing other people's money and have a moral duty to act as a responsible agent for the owners. In law, this is called the manager's fiduciary duty. Directors have the same duties toward shareholders. Friedman emphasized the primacy of this duty in his writings about corporations and social responsibility.

Maximizing Profits: Milton Friedman

Economist Milton Friedman is often quoted as having said that the only moral duty a corporation has is to make the most possible money, or to maximize profits, for its stockholders. Friedman's beliefs are noted at length (see sidebar on Friedman's article from the *New York Times*), but he asserted in a now-famous 1970 article that in a free society, "there is one and only one social responsibility of business: to use its resources and engage in activities designed to increase its profits as long as it stays within the rules of the game, which is to say, engages in open and free competition without deception and fraud." What follows is a major portion of what Friedman had to say in 1970.

"The Social Responsibility of Business Is to Increase Its Profits"

Milton Friedman, *New York Times Magazine*, September 13, 1970

What does it mean to say that "business" has responsibilities? Only people can have responsibilities. A corporation is an artificial person and in this sense may have artificial responsibilities, but "business" as a whole cannot be said to have responsibilities, even in this vague sense.…

Presumably, the individuals who are to be responsible are businessmen, which means individual proprietors or corporate executives.…In a free enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.…

…[T]he manager is that agent of the individuals who own the corporation or establish the eleemosynary institution, and his primary responsibility is to them…

Of course, the corporate executive is also a person in his own right. As a person, he may have other responsibilities that he recognizes or assumes voluntarily—to his family, his conscience, his feeling of charity, his church, his clubs, his city, his country. He may feel impelled by these responsibilities to devote part of his income to causes he regards as worthy, to refuse to work for particular corporations, even to leave his job…But in these respects he is acting as a principal, not an agent; he is spending his own money or time or energy, not the money of his employers or the time or energy he has contracted to devote to their purposes. If these are "social responsibilities," they are the social responsibilities of individuals, not of business.

What does it mean to say that the corporate executive has a "social responsibility" in his capacity as businessman? If this statement is not pure rhetoric, it must mean that he has to act in some way that is not in the interest of his employers. For example, that he is to refrain from increasing the price of the product in order to contribute to the social objective of preventing inflation, even though a price increase would be in the best interests of the corporation. Or that he is to make expenditures on reducing pollution beyond the amount that is in the best interests of the corporation or that is required by law in order to contribute to the social objective of improving the environment. Or that, at the expense of corporate profits, he is to hire "hardcore" unemployed instead of better qualified available workmen to contribute to the social objective of reducing poverty.

In each of these cases, the corporate executive would be spending someone else's money for a general social interest. Insofar as his actions…reduce returns to stockholders, he is spending their money. Insofar as his actions raise the price to customers, he is spending the customers' money. Insofar as his actions lower the wages of some employees, he is spending their money.

This process raises political questions on two levels: principle and consequences. On the level of political principle, the imposition of taxes and the expenditure of tax proceeds are governmental functions. We have established elaborate constitutional, parliamentary, and judicial provisions to control these functions, to assure that taxes are imposed so far as possible in accordance with the preferences and desires of the public.…

Others have challenged the notion that corporate managers have no real duties except toward the owners (shareholders). By changing two letters in shareholder, stakeholder theorists widened the range of people and institutions that a corporation should pay moral consideration to. Thus they contend that a corporation, through its management, has a set of responsibilities toward nonshareholder interests.

Stakeholder Theory

Stakeholders of a corporation include its employees, suppliers, customers, and the community. Stakeholder is a deliberate play on the word *shareholder*, to emphasize that corporations have obligations that extend beyond the bottom-line aim of maximizing profits. A stakeholder is anyone who most would agree is significantly affected (positively or negatively) by the decision of another moral agent.

There is one vital fact about corporations: the corporation is a creation of the law. Without law (and government), corporations would not have existence. The key concept for corporations is the legal fact of limited liability. The benefit of limited liability for shareholders of a corporation meant that larger pools of capital could be aggregated for larger enterprises; shareholders could only lose their investments should the venture fail in any way, and there would be no personal liability and thus no potential loss of personal assets other than the value of the corporate stock. Before New Jersey and Delaware competed to make incorporation as easy as possible and beneficial to the incorporators and founders, those who wanted the benefits of incorporation had to go to legislatures—usually among the states—to show a public purpose that the company would serve.

In the late 1800s, New Jersey and Delaware changed their laws to make incorporating relatively easy. These two states allowed incorporation "for any legal purpose," rather than requiring some public purpose. Thus it is government (and its laws) that makes limited liability happen through the corporate form. That is, only through the consent of the state and armed with the charter granted by the state can a corporation's shareholders have limited liability. This is a right granted by the state, a right granted for good and practical reasons for encouraging capital and innovation. But with this right comes a related duty, not clearly stated at law, but assumed when a charter is granted by the state: that the corporate form of doing business is legal because the government feels that it socially useful to do so.

Implicitly, then, there is a social contract between governments and corporations: as long as corporations are considered socially useful, they can exist. But do they have explicit social responsibilities? Milton Friedman's position suggests that having gone along with legal duties, the corporation can ignore any other social obligations. But there are others (such as advocates of stakeholder theory) who would say that a corporation's social responsibilities go beyond just staying within the law and go beyond the corporation's shareholders to include a number of other important stakeholders, those whose lives can be affected by corporate decisions.

According to stakeholder theorists, corporations (and other business organizations) must pay attention not only to the bottom line but also to their overall effect on the community. Public perception of a company's unfairness, uncaring, disrespect, or lack of trustworthiness often leads to long-term failure, whatever the short-term successes or profits may be. A socially responsible corporation is likely to consider the impact of its decisions on a wide range of stakeholders, not just shareholders. As Table 2.4.1 indicates, stakeholders have very different kinds of interests ("stakes") in the actions of a corporation.

Table 2.4.1: The Stakes of Various Stakeholders

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

Corporate Culture and Codes of Ethics

A corporation is a “person” capable of suing, being sued, and having rights and duties in our legal system. (It is a legal or juridical person, not a natural person, according to our Supreme Court.) Moreover, many corporations have distinct cultures and beliefs that are lived and breathed by its members. Often, the culture of a corporation is the best defense against individuals within that firm who may be tempted to break the law or commit serious ethical misdeeds.

What follows is a series of observations about corporations, ethics, and corporate culture.

Ethical Leadership Is Top-Down

People in an organization tend to watch closely what the top managers do and say. Regardless of managers’ talk about ethics, employees quickly learn what speech or actions are in fact rewarded. If the CEO is firm about acting ethically, others in the organization will take their cues from him or her. People at the top tend to set the target, the climate, the beliefs, and the expectations that fuel behavior.

Accountability Is Often Weak

Clever managers can learn to shift blame to others, take credit for others’ work, and move on before “funny numbers” or other earnings management tricks come to light.See Robert Jackall, *Moral Mazes: The World of Corporate Managers* (New York: Oxford University Press, 1988). Again, we see that the manager is often an agent for himself or herself and will often act more in his or her self-interest than for the corporate interest.

Killing the Messenger

Where organizations no longer function, inevitably some employees are unhappy. If they call attention to problems that are being covered up by coworkers or supervisors, they bring bad news. Managers like to hear good news and discourage bad news. Intentionally or not, those who told on others, or blew the whistle, have rocked the boat and become unpopular with those whose defalcations they report on and with the managers who don’t really want to hear the bad news. In many organizations, “killing the messenger” solves the problem. Consider James Alexander at Enron Corporation, who was deliberately shut out after bringing problems to CEO Ken Lay’s attention. John Schwartz, “An Enron Unit Chief Warned, and Was Rebuffed,” *New York Times*, February 20, 2002. When Sherron Watkins sent Ken Lay a letter warning him about Enron’s accounting practices, CFO Andrew Fastow tried to fire her.Warren Bennis, “A Corporate Fear of Too Much Truth,” *New York Times*, February 17, 2002.

Ethics Codes

Without strong leadership and a willingness to listen to bad news as well as good news, managers do not have the feedback necessary to keep the organization healthy. Ethics codes have been put in place—partly in response to federal sentencing guidelines and partly to encourage feedback loops to top management. The best ethics codes are aspirational, or having an ideal to be pursued, not legalistic or compliance driven. The Johnson & Johnson ethics code predated the Tylenol scare and the company’s oft-celebrated corporate response.University of Oklahoma Department of Defense Joint Course in Communication, *Case Study: The Johnson & Johnson Tylenol Crisis*, accessed April 5, 2011. The corporate response was consistent with that code, which was lived and modeled by the top of the organization.

It’s often noted that a code of ethics is only as important as top management is willing to make it. If the code is just a document that goes into a drawer or onto a shelf, it will not effectively encourage good conduct within the corporation. The same is true of any kind of training that the company undertakes, whether it be in racial sensitivity or sexual harassment. If the message is not continuously reinforced, or (worse yet) if the message is undermined by management’s actions, the real message to employees is that violations of the ethics code will not be taken seriously, or that efforts to stop racial discrimination or sexual harassment are merely token efforts, and that the important things are profits and performance. The ethics code at Enron seems to have been one of those “3-P” codes that wind up sitting on shelves—“Print, Post, and Pray.” Worse, the Enron board twice suspended the code in 1999 to allow outside partnerships to be led by a top Enron executive who stood to gain financially from them.

Ethics Hotlines and Federal Sentencing Guidelines

The federal sentencing guidelines were enacted in 1991. The original idea behind these guidelines was for Congress to correct the lenient treatment often given to white-collar, or corporate, criminals. The guidelines require judges to consider "aggravating and mitigating" factors in determining sentences and fines. (While corporations cannot go to jail, its officers and managers certainly can, and the corporation itself can be fined. Many companies will claim that it is one bad apple that has caused the problem; the guidelines invite these companies to show that they are in fact tending their orchard well. They can show this by providing evidence that they have (1) a viable, active code of ethics; (2) a way for employees to report violations of law or the ethics code; and (3) an ethics ombudsman, or someone who oversees the code.

In short, if a company can show that it has an ongoing process to root out wrongdoing at all levels of the company, the judge is allowed to consider this as a major mitigating factor in the fines the company will pay. Most Fortune 500 companies have ethics hotlines and processes in place to find legal and ethical problems within the company.

Managing by the Numbers

If you manage by the numbers, there is a temptation to lie about those numbers, based on the need to get stock price ever higher. At Enron, "15 percent a year or better earnings growth" was the mantra. Jeffrey Pfeffer, professor of organizational behavior at Stanford University, observes how the belief that "stock price is all that matters" has been hardwired into the corporate psyche. It dictates not only how people judge the worth of their company but also how they feel about themselves and the work that they are doing. And, over time, it has clouded judgments about what is acceptable corporate behavior.Steven Pearlstein, "Debating the Enron Effect," *Washington Post*, February 17, 2002.

Managing by Numbers: The Sears Auto Center Story

> *If winning is the most important thing in your life, then you must be prepared to do anything to win.*
>
> *—Michael Josephson*

Most people want to be winners or associate with winners. As humans, our desire to associate with those who have status provides plenty of incentive to glorify winners and ignore losers. But if an individual, a team, or a company does whatever it takes to win, then all other values are thrown out in the goal to win at all costs. The desire of some people within Sears & Roebuck Company's auto repair division to win by gaining higher profits resulted in the situation portrayed here.

Sears Roebuck & Company has been a fixture in American retailing throughout the twentieth century. At one time, people in rural America could order virtually anything (including a house) from Sears. Not without some accuracy, the company billed itself as "the place where Americans shop." But in 1992, Sears was charged by California authorities with gross and deliberate fraud in many of its auto centers.

The authorities were alerted by a 50 percent increase in consumer complaints over a three-year period. New Jersey's division of consumer affairs also investigated Sears Auto Centers and found that all six visited by investigators had recommended unnecessary repairs. California's department of consumer affairs found that Sears had systematically overcharged by an average of $223 for repairs and routinely billed for work that was not done. Sears Auto Centers were the largest providers of auto repair services in the state.

The scam was a variant on the old bait-and-switch routine. Customers received coupons in the mail inviting them to take advantage of hefty discounts on brake jobs. When customers came in to redeem their coupons, sales staffers would convince them to authorize additional repairs. As a management tool, Sears had also established quotas for each of their sales representatives to meet.

Ultimately, California got Sears to settle a large number of lawsuits against it by threatening to revoke Sears' auto repair license. Sears agreed to distribute $50 coupons to nearly a million customers nationwide who had obtained certain services between August 1, 1990, and January 31, 1992. Sears also agreed to pay $3.5 million to cover the costs of various government investigations and to contribute $1.5 million annually to conduct auto mechanic training programs. It also agreed to abandon its repair service quotas. The entire settlement cost Sears $30 million. Sears Auto Center sales also dropped about 15 to 20 percent after news of the scandal broke. Sears Auto Center, like Sears itself, eventually went out of business.

Note that in boosting sales by performing unnecessary services, Sears suffered very bad publicity. Losses were incalculable. The short-term gains were easy to measure; long-term consequences seldom are. The case illustrates a number of important lessons:

- People generally choose short-term gains over potential long-term losses.
- People often justify the harm to others as being minimal or "necessary" to achieve the desired sales quota or financial goal.
- In working as a group, we often form an "us versus them" mentality. In the Sears case, it is likely that Sears "insiders" looked at customers as "outsiders," effectively treating them (in Kantian terms) as means rather than ends in themselves. In short, outsiders were used for the benefit of insiders.
- The long-term losses to Sears are difficult to quantify, while the short-term gains were easy to measure and (at least for a brief while) quite satisfying financially.
- Sears' ongoing rip-offs were possible only because individual consumers lacked the relevant information about the service being offered. This lack of information is a market failure, since many consumers were demanding more of Sears Auto Center services than they would have (and at a higher price) if relevant information had been available to them earlier. Sears, like other sellers of goods and services, took advantage of a market system, which, in its ideal form, would not permit such information distortions.
- People in the organization probably thought that the actions they took were necessary.

Noting this last point, we can assume that these key people were motivated by maximizing profits and had lost sight of other goals for the organization.

The emphasis on doing whatever is necessary to win is entirely understandable, but it is not ethical. The temptation will always exist—for individuals, companies, and nations—to dominate or to win and to write the history of their actions in a way that justifies or overlooks the harm that has been done. In a way, this fits with the notion that "might makes right," or that power is the ultimate measure of right and wrong.

Conscious Capitalism

One effort to integrate the two viewpoints of stakeholder theory and shareholder primacy is the conscious capitalism movement. Companies that practice conscious capitalism embrace the idea that profit and prosperity can and must go hand in hand with social justice and environmental stewardship. They operate with a holistic or systems view. This means that they understand that all stakeholders are connected and interdependent. They reject false trade-offs between stakeholder interests and strive for creative ways to achieve win-win-win outcomes for all.

The "conscious business" has a purpose that goes beyond maximizing profits. It is designed to maximize profits but is focused more on its higher purpose and does not fixate solely on the bottom line. To do so, it focuses on delivering value to all its stakeholders, harmonizing as best it can the interests of consumers, partners, investors, the community, and the environment. This requires that company managers take a "servant leadership" role, serving as stewards to the company's deeper purpose and to the company's stakeholders.

Conscious business leaders serve as such stewards, focusing on fulfilling the company's purpose, delivering value to its stakeholders, and facilitating a harmony of interests, rather than on personal gain and self-aggrandizement. Why is this refocusing needed? Within the standard profit-maximizing model, corporations have long had to deal with the "agency problem." Actions by top-level managers—acting on behalf of the company—should align with the shareholders, but in a culture all about winning and money, managers sometimes act in ways that are self-aggrandizing and that do not serve the interests of shareholders. Laws exist to limit such self-aggrandizing, but the remedies are often too little and too late and often catch only the most egregious overreaching. Having a culture of servant leadership is a much better way to see that a company's top management works to ensure a harmony of interests.

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2.5: Summary and Exercises

Summary

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

Exercises

1. Consider again Milton Friedman's article.

    a. What does Friedman mean by "ethical custom"?
    b. If the laws of the society are limiting the company's profitability, would the company be within its rights to disobey the law?
    c. What if the law is "on the books," but the company could count on a lack of enforcement from state officials who were overworked and underpaid? Should the company limit its profits? Suppose that it could save money by discharging a pollutant into a nearby river, adversely affecting fish and, potentially, drinking water supplies for downstream municipalities. In polluting against laws that aren't enforced, is it still acting "within the rules of the game"? What if almost all other companies in the industry were saving money by doing similar acts?

2. Consider again the *Harris v. Forklift* case at the end of Chapter 1. The Supreme Court ruled that Ms. Harris was entitled to be heard again by the federal district court, which means that there would be a trial on her claim that Mr. Hardy, owner of Forklift Systems, had created a "hostile working environment" for Ms. Harris. Apart from the legal aspects, did he really do anything unethical? How can you tell?

    a. Which of his actions, if any, were contrary to utilitarian thinking?
    b. If Kant were his second-in-command and advising him on ethical matters, would he have approved of Mr. Hardy's behavior? Why or why not?

3. Consider the behaviors alleged by Ms. Harris and assume for a moment that they are all true. In terms of core values, which of these behaviors are not consistent with the core values Josephson points to? Be specific.

4. Assume that Forklift Systems is a large public corporation and that the CEO engages in these kinds of behaviors. Assume also that the board of directors knows about it. What action should the board take, and why?

5. Assume that the year is 1963, prior to the passage of the Civil Rights Act of 1964 and the Title VII provisions regarding equal employment opportunity that prohibit discrimination based on sex. So, Mr. Hardy's actions are not illegal, fraudulent, or deceitful. Assume also that he heads a large public company and that there is a large amount of turnover and unhappiness among the women who work for the company. No one can sue him for being sexist or lecherous, but are his actions consistent with maximizing shareholder returns? Should the board be concerned?Notice that this question is really a stand-in for any situation faced by a company today regarding its CEO where the actions are not illegal but are ethically questionable. What would conscious capitalism tell a CEO or a board to do where some group of its employees are regularly harassed or disadvantaged by top management?

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CHAPTER OVERVIEW

3: Courts and the Legal Process

Learning Objectives

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

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

In the United States, law and government are interdependent. The Constitution establishes the basic framework of government and imposes certain limitations on the powers of government. In turn, the various branches of government are intimately involved in making, enforcing, and interpreting the law. Today, much of the law comes from Congress and the state legislatures. But it is in the courts that legislation is interpreted and prior case law is interpreted and applied.

3.1: Introduction to the Courts and the Legal Process
3.2: The Relationship between State and Federal Court Systems in the United States
3.3: The Problem of Jurisdiction
3.4: Motions and Discovery
3.5: The Pretrial and Trial Phase
3.6: Judgment, Appeal, and Execution
3.7: When Can Someone Bring a Lawsuit?
3.8: Relations with Lawyers
3.9: Alternative Means of Resolving Disputes

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3.1: Introduction to the Courts and the Legal Process

As we go through this chapter, please keep in mind a couple of items.

First, understand that "jurisdiction" and "venue" are separate concepts. "Jurisdiction" means power. For courts to hear a case, it must have jurisdiction over the subject matter and persons before the court. In other words, it must have the lawful power to hear the type of case and to issue rulings that bind the parties in the case before it. "Venue" means location within a court system. California courts may have jurisdiction over a defendant charged with burglary committed in the state, but deciding *which* of California's 58 Superior Courts should hear the case is a matter of venue.

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

Robinson v. Audi

Harry and Kay Robinson purchased a new Audi automobile from Seaway Volkswagen, Inc. (Seaway), in Massena, New York, in 1976. The following year the Robinson family, who resided in New York, left that state for a new home in Arizona. As they passed through Oklahoma, another car struck their Audi in the rear, causing a fire that severely burned Kay Robinson and her two children. Later on, the Robinsons brought a products-liability action in the District Court for Creek County, Oklahoma, claiming that their injuries resulted from the defective design and placement of the Audi's gas tank and fuel system. They sued numerous defendants, including the automobile's manufacturer, Audi NSU Auto Union Aktiengesellschaft (Audi); its importer, Volkswagen of America, Inc. (Volkswagen); its regional distributor, World-Wide Volkswagen Corp. (World-Wide); and, its retail dealer, Seaway.

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

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

Learning Objectives

After reading this chapter, you should understand the following:

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

Although it is sometimes said that there are two separate court systems, the reality is more complex. There are, in fact, fifty-two court systems: those of the fifty states, the local court system in the District of Columbia, and the federal court system. At the same time, these are not entirely separate; they all have several points of contact.

State and local courts must honor both federal law and the laws of the other states. First, state courts must honor federal law where state laws are in conflict with federal laws (under the supremacy clause of the Constitution; see Chapter 4). Second, claims arising under federal statutes can often be tried in the state courts, where the Constitution or Congress has not explicitly required that only federal courts can hear that kind of claim. Third, under the full faith and credit clause, each state court is obligated to respect the final judgments of courts in other states. Thus, a contract dispute resolved by an Arkansas court cannot be relitigated in North Dakota when the plaintiff wants to collect on the Arkansas judgment in North Dakota. Fourth, state courts often must consider the laws of other states in deciding cases involving issues where two states have an interest, such as when drivers from two different states collide in a third state. Under these circumstances, state judges will consult their own state's case decisions involving conflicts of laws and sometimes decide that they must apply another state's laws to decide the case (see Table 3.1).

As state courts are concerned with federal law, so federal courts are often concerned with state law and with what happens in state courts. Federal courts will consider state-law-based claims when a case involves claims using both state and federal law. Claims based on federal laws will permit the federal court to take jurisdiction over the whole case, including any state issues raised. In those cases, the federal court is said to exercise "pendent jurisdiction" over the state claims. Also, the Supreme Court will occasionally take appeals from a state supreme court where state law raises an important issue of federal law to be decided. For example, a convict on death row may claim that the state's chosen method of execution using the injection of drugs is unusually painful and involves "cruel and unusual punishment," raising an issue of federal law under the Eighth Amendment of the US Constitution.

There is also a broad category of cases heard in federal courts that concern only state legal issues—namely, cases that arise between citizens of different states. The federal courts are permitted to hear these cases under their so-called diversity of citizenship jurisdiction (or diversity jurisdiction). A citizen of New Jersey may sue a citizen of New York over a contract dispute in federal court, but if both were citizens of New Jersey, the plaintiff would be limited to the state courts. The Constitution established diversity jurisdiction because it was feared that local courts would be hostile toward people from other states and that they would need separate courts. In 2009, nearly a third of all lawsuits filed in federal court were based on diversity of citizenship. In these cases, the federal courts were applying state law, rather than taking federal question jurisdiction, where federal law provided the basis for the lawsuit or where the United States was a party (as plaintiff or defendant).

Why are there so many diversity cases in federal courts? Defense lawyers believe that there is sometimes a "home-court advantage" for an in-state plaintiff who brings a lawsuit against a nonresident in his local state court. The defense attorney is entitled to ask for removal to a federal court where there is diversity. This fits with the original reason for diversity jurisdiction in the Constitution—the concern that judges in one state court would favor the in-state plaintiff rather than a nonresident defendant. Another reason there are so many diversity cases is that plaintiffs' attorneys know that removal is common and that it will move the case along faster by filing in federal court to begin with. Some plaintiffs' attorneys also find advantages in pursuing a lawsuit in federal court. Federal court procedures are often more efficient than state court procedures, so that federal dockets are often less crowded. This means a case will get to trial faster, and many lawyers enjoy the higher status that comes in practicing before the federal bench. In some federal districts, judgments for plaintiffs may be higher, on average, than in the local state court. In short, not only law but also legal strategy factor into the popularity of diversity cases in federal courts.

State Court Systems

The vast majority of civil lawsuits in the United States are filed in state courts. Two aspects of civil lawsuits are common to all state courts: trials and appeals. A court exercising a trial function has original jurisdiction—that is, jurisdiction to determine the facts of the case and apply the law to them. A court that hears appeals from the trial court is said to have appellate jurisdiction—it must accept the facts as determined by the trial court and limit its review to the lower court's theory of the applicable law. This means an appeal is not a retrial; rather, the appellate court looks to whether the trial court applied the law correctly.

Limited Jurisdiction Courts

In most large urban states and many smaller states, there are four and sometimes five levels of courts. The lowest level is that of the limited jurisdiction courts. These are usually county or municipal courts with original jurisdiction to hear minor criminal cases (petty assaults, traffic offenses, and breach of peace, among others) and civil cases involving monetary amounts up to a fixed ceiling (no more than $10,000 in most states and far less in many states). Most disputes that wind up in court are handled in the 18,000-plus limited jurisdiction courts, which are estimated to hear more than 80 percent of all cases.

One familiar limited jurisdiction court is the small claims court, with jurisdiction to hear civil cases involving claims for amounts ranging between $1,000 and $5,000 in about half the states and for considerably less in the other states ($500 to $1,000). In California, a plaintiff can sue for up to $12,500. The advantage of the small claims court is that its procedures are informal, it is often located in a neighborhood outside the business district, it is usually open after business hours, and it is speedy. Lawyers are not necessary to present the case and in some states, such as California, they are not allowed to appear in court.

General Jurisdiction Courts

All other civil and criminal cases are heard in the general trial courts, or courts of general jurisdiction. These go by a variety of names: superior, circuit, district, or common pleas court (in California, the court of general jurisdiction is the Superior Court). These are the courts in which people seek redress for incidents such as automobile accidents and injuries, or breaches of contract. These state courts also prosecute those accused of murder, rape, robbery, and other serious crimes. The fact finder in these general jurisdiction courts is not a judge, as in the lower courts, but a jury of citizens. The general jurisdiction court serving Santa Ana, California is the Superior Court of California, County of Orange. It has several branches, including its Central Justice Center located at 700 West Civic Center Drive, Santa Ana.

Although courts of general jurisdiction can hear all types of cases, in most states more than half involve family matters (divorce, child custody disputes, and the like). A third were commercial cases, (often involving breach of contract claims) and slightly over 10 percent were devoted to car accident cases and other torts (as discussed in Chapter 7). Most states have specialized courts that hear only a certain type of case, such as landlord-tenant disputes or probate of wills.

Appellate Courts

The losing party in a general jurisdiction court can almost always appeal to either one or two higher courts. These intermediate appellate courts—usually called courts of appeal—have been established in forty states, including California which has a Court of Appeal divided into six geographic districts. The intermediate appellate courts are usually composed of panels of three judges and are situated in various locations around the state. They do not retry the evidence, but rather determine whether the trial was conducted in a procedurally correct manner and whether the appropriate law was applied. For example, the appellant (the losing party who appeals) might complain that the judge wrongly instructed the jury on the meaning of the law, or improperly allowed testimony of a particular witness, or misconstrued the law in question. The respondent (who won in the lower court) will ask that the appellant be denied—usually this means that the respondent wants the lower-court judgment affirmed. The appellate court has quite a few choices: it can affirm, modify, reverse, or reverse and remand the lower court (return the case to the lower court for retrial).

The last type of appeal within the state courts system is to the highest court, the state supreme court, which is composed of a single panel of between five and nine judges and is usually located in the state capital. In a few states, the highest court goes by a different name: in New York, it is known as the court of appeals. California's highest court is the Supreme Court on which seven justices serve. In certain cases, appellants to the highest court in a state have the right to have their appeals heard, but more often the supreme court selects the cases it wishes to hear. The state supreme court is the highest interpretive authority of state law. Its rulings on state law are binding. For most litigants, the ruling of the state supreme court is final. In a relatively small class of cases

—those in which federal constitutional claims are made—appeal to the US Supreme Court to issue a writ of certiorari remains a possibility.

The Federal Court System

District Courts

The federal judicial system is uniform throughout the United States and consists of three levels. At the first level are the federal district courts, which are the trial courts in the federal system. Every state has one or more federal districts; the less populous states have one, and the more populous states (California, Texas, and New York) have four. The federal court with the heaviest commercial docket is the US District Court for the Southern District of New York (Manhattan). There are forty-four district judges and fifteen magistrates in this district. The district judges throughout the United States commonly preside over all federal trials, both criminal and civil. The District Court serving Santa Ana, California is the United States District Court for the Central District. This court has a division in Santa Ana, located at the Ronald Reagan Federal Building and United States Courthouse on Fourth Street.

Courts of Appeal

Cases from the district courts can then be appealed to the circuit courts of appeal, of which there are thirteen (Figure 3.1). Each circuit oversees the work of the district courts in several states. For example, the US Court of Appeals for the Second Circuit hears appeals from district courts in New York, Connecticut, and Vermont. The US Court of Appeals for the Ninth Circuit hears appeals from district courts in California, Oregon, Nevada, Montana, Washington, Idaho, Arizona, Alaska, Hawaii, and Guam. The US Court of Appeals for the District of Columbia Circuit hears appeals from the district court in Washington, DC, as well as from numerous federal administrative agencies (see Chapter 5). The US Court of Appeals for the Federal Circuit, also located in Washington, hears appeals in patent and customs cases. Appeals are usually heard by three-judge panels, but sometimes there will be a rehearing at the court of appeals level, in which case all judges sit to hear the case “en banc.”

There are also several specialized courts in the federal judicial system. These include the US Tax Court, the Court of Customs and Patent Appeals, and the Court of Claims.

United States Supreme Court

Overseeing all federal courts is the US Supreme Court, in Washington, DC. It consists of nine justices—the chief justice and eight associate justices. (This number is not constitutionally required; Congress can establish any number. It has been set at nine since after the Civil War.) The Supreme Court has selective control over most of its docket. By law, the cases it hears represent only a tiny fraction of the cases that are submitted. In 2024, the Supreme Court had numerous petitions (nearly 5,000) but only agreed to hear arguments in only 69 cases. The Supreme Court does not sit in panels. All the justices hear and consider each case together, unless a justice has a conflict of interest and must withdraw from hearing the case.



Figure 3.1 The Federal Judicial Circuits

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

Key Takeaway

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

Exercises

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

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3.3: The Problem of Jurisdiction

Learning Objectives

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

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

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

There are two questions about jurisdiction in each case that must be answered before a judge will hear a case: the question of subject matter jurisdiction and the question of personal jurisdiction. We will consider the question of subject matter jurisdiction first, because judges do; if they determine, on the basis of the initial documents in the case (the "pleadings"), that they have no power to hear and decide that kind of case, they will dismiss it.

The Federal-State Balance: Federalism

State courts have their origins in colonial era courts. After the American Revolution, state courts functioned (with some differences) much like they did in colonial times. The big difference after 1789 was that state courts coexisted with federal courts. Federalism was the system devised by the nation's founders in which power is shared between states and the federal government. This sharing requires a division of labor between the states and the federal government. It is Article III of the US Constitution that spells out the respective spheres of authority (jurisdiction) between state and federal courts.

Take a close look at Article III of the Constitution. Article III makes clear that federal courts are courts of limited power or jurisdiction. Notice that the only kinds of cases federal courts are authorized to deal with have strong federal connections. For example, federal courts have jurisdiction when a federal law is being used by the plaintiff or prosecutor (a "federal question" case) or the case arises "in admiralty" (meaning that the problem arose not on land but on sea, beyond the territorial jurisdiction of any state, or in navigable waters within the United States). Implied in this list is the clear notion that states would continue to have their own laws, interpreted by their own courts, and that federal courts were needed only where the issues raised by the parties had a clear federal connection. The exception to this is diversity jurisdiction, discussed later.

The Constitution was constructed with the idea that state courts would continue to deal with basic kinds of claims such as tort, contract, or property claims. Since states sanction marriages and divorce, state courts would deal with "domestic" (family) issues. Since states deal with birth and death records, it stands to reason that paternity suits, probate disputes, and the like usually wind up in state courts. You wouldn't go to the federal building or courthouse to get a marriage license, ask for a divorce, or probate a will: these matters have traditionally been dealt with by the states (and the thirteen original colonies before them). Matters that historically get raised and settled in state court under state law include not only domestic and probate matters but also law relating to corporations, partnerships, agency, contracts, property, torts, and commercial dealings generally. You cannot get married or divorced in federal court, because federal courts have no jurisdiction over matters that are historically (and are still) exclusively within the domain of state law.

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

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

Always remember: a court must have subject matter jurisdiction to hear and decide a case. Without it, a court cannot address the merits of the controversy or even take the next jurisdictional step of figuring out which of the defendants can be sued in that court. The question of which defendants are appropriately before the court is a question of personal jurisdiction.

Because there are two court systems, it is important for a plaintiff to file in the right court to begin with. The right court is the one that has subject matter jurisdiction over the case—that is, the power to hear and decide the kind of case that is filed. Not only is it a waste of time to file in the wrong court system and be dismissed, but if the dismissal comes after the filing period imposed by the applicable statute of limitations, it will be too late to refile in the correct court system. Such cases will be routinely dismissed, regardless of how deserving the plaintiff might be in his quest for justice. (The plaintiff's only remedy at that point would be to sue his lawyer for negligence for failing to mind the clock and get to the right court in time!)

Exclusive Jurisdiction in Federal Courts

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

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

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

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

9. *Other cases specified by federal statute*. Any other cases specified by a federal statute where Congress declares that federal courts will have exclusive jurisdiction.

Concurrent Jurisdiction

When a plaintiff takes a case to state court, it will be because state courts typically hear that kind of case (i.e., there is subject matter jurisdiction). If the plaintiff's main cause of action comes from a certain state's constitution, statutes, or court decisions, the state courts have subject matter jurisdiction over the case. If the plaintiff's main cause of action is based on federal law (e.g., Title VII of the Civil Rights Act of 1964), the federal courts have subject matter jurisdiction over the case. But federal courts will also have subject matter jurisdiction over certain cases that have only a state-based cause of action; those cases are ones in which the plaintiff(s) and the defendant(s) are from different states and the amount in controversy is more than $75,000. State courts can have subject matter jurisdiction over certain cases that have only a federal-based cause of action. The Supreme Court has now made clear that state courts have concurrent jurisdiction of any federal cause of action unless Congress has given exclusive jurisdiction to federal courts.

In short, a case with a federal question can be often be heard in either state or federal court, and a case that has parties with a diversity of citizenship can be heard in state courts or in federal courts where the tests of complete diversity and amount in controversy are met. (See Note 3.18 "Summary of Rules on Subject Matter Jurisdiction".)

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

Summary of Rules on Subject Matter Jurisdiction

1. A court must always have subject matter jurisdiction, and personal jurisdiction over at least one defendant, to hear and decide a case.

2. A state court will have subject matter jurisdiction over any case that is not required to be brought in a federal court. Some cases can *only* be brought in federal court, such as bankruptcy cases, cases involving federal crimes, patent cases, and Internal Revenue Service tax court claims. The list of cases for exclusive federal jurisdiction is fairly short. That means that almost any state court will have subject matter jurisdiction over almost any kind of case. If it's a case based on state law, a state court will always have subject matter jurisdiction.

3. A federal court will have subject matter jurisdiction over any case that is either based on a federal law (statute, case, or US Constitution)ORA federal court will have subject matter jurisdiction over any case based on state law where the parties are (1) from different states and (2) the amount in controversy is at least $75,000. The different states requirement means that no plaintiff can have permanent residence in a state where any defendant has permanent residence—there must be complete diversity of citizenship as between all plaintiffs and defendants.

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

4. In diversity cases, the following rules apply.

(a) Federal civil procedure rules apply to how the case is conducted before and during trial and any appeals;

(b) State law will be used as the basis for a determination of legal rights and responsibilities. This "choice of law" process is interesting but complicated. Basically, each state has its own set of judicial decisions that resolve conflict of laws. For example, just because A sues B in a Texas court, the Texas court will not necessarily apply Texas law. Anna and Bobby collide and suffer serious physical injuries while driving their cars in Roswell, New Mexico. Both live in Austin, and Bobby files a lawsuit in Austin. The court there could hear it (having subject matter jurisdiction and personal jurisdiction over Bobby) but would apply New Mexico law, which governs motor vehicle laws and accidents in New Mexico. Why would the Texas judge do that? The Texas judge knows that which state's law is chosen to apply to the case can make a decisive difference in the case, as different states have different substantive law standards. For example, in a breach of contract case, one state's version of the Uniform Commercial Code may be different from another's, and which one the court decides to apply is often exceedingly good for one side and dismal for the other. In *Anna v. Bobby*, if Texas has one kind of comparative negligence statute and New Mexico has a different kind of comparative negligence statute, who wins or loses, or how much

is awarded, could well depend on which law applies. Because both were under the jurisdiction of New Mexico's laws at the time, it makes sense to apply New Mexico law.

5. Why do some nonresident defendants prefer to be in federal court?

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

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

6. If a defendant does not want to be in state court and there is diversity, what is to be done?

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

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

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

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

Robinson v. Audi

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

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

If they wish to go to federal court, can they? There is no federal question presented here (the claim is based on state common law), and the United States is not a party, so the only basis for federal court jurisdiction would be diversity jurisdiction. If enough time has elapsed since the accident and they have established themselves as Arizona residents, they could sue in federal court in Oklahoma (or elsewhere), but only if none of the defendants—the retailer, the regional Volkswagen company, Volkswagen of North America, or Audi (in Germany) are incorporated in or have a principal place of business in Arizona. The federal judge would decide the case using federal civil procedure but would have to make the appropriate choice of state law. In this case, the choice of conflicting laws would most likely be Oklahoma, where the accident happened, or New York, where the defective product was sold.

Table 3.3.1: Sample Conflict-of-Law Principles

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

Legal Procedure, Including Due Process and Personal Jurisdiction

In this section, we consider how lawsuits are begun and how the court knows that it has both subject matter jurisdiction and personal jurisdiction over at least one of the named defendants.

The courts are not the only institutions that can resolve disputes. In Section 3.8, we will discuss other dispute-resolution forums, such as arbitration and mediation. For now, let us consider how courts make decisions in civil disputes. Judicial decision making in the context of litigation (civil lawsuits) is a distinctive form of dispute resolution.

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

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

This is at the heart of the adversary system, in which those who oppose each other may attack the other's case through proofs and cross-examination. Every person in the United States who wishes to take a case to court is entitled to hire a lawyer. The lawyer works for her client, not the court, and serves her as an advocate, or supporter. The client's goal is to persuade the court of the accuracy and justness of his position. The lawyer's duty is to shape the evidence and the argument—the line of reasoning about the evidence—to advance his client's cause and persuade the court of its rightness. The lawyer for the opposing party will be doing the same thing, of course, for her client. The judge (or, if one is sitting, the jury) must sort out the facts and reach a decision from this cross-fire of evidence and argument.

The method of adjudication—the act of making an order or judgment—has several important features. First, it focuses the conflicting issues. Other, secondary concerns are minimized or excluded altogether. Relevance is a key concept in any trial. The judge is required to decide the questions presented at the trial, not to talk about related matters. Second, adjudication requires that the judge's decision be reasoned, and that is why judges write opinions explaining their decisions (an opinion may be omitted when the verdict comes from a jury). Third, the judge's decision must not only be reasoned but also be responsive to the case presented: the judge is not free to say that the case is unimportant and that he therefore will ignore it. Unlike other branches of government that are free to ignore problems pressing upon them, judges *must* decide cases. (For example, a legislature need not enact a law, no matter how many people petition it to do so.) Fourth, the court must respond in a certain way. The judge must pay attention to the parties' arguments and his decision must result from their proofs and arguments. Evidence that is not presented and legal arguments that are not made cannot be the basis for what the judge decides. Also, judges are bound by standards of weighing evidence: the burden of proof in a civil case is generally a "preponderance of the evidence."

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

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

By contrast, the burden of proof in ordinary civil cases—those dealing with contracts, personal injuries, and most of the cases in this book—is a *preponderance of the evidence*, which means that the plaintiff's evidence must outweigh whatever evidence the defendant can muster that casts doubts on the plaintiff's claim. This is not merely a matter of counting the number of witnesses or of the length of time that they talk: the judge in a trial without a jury (a bench trial), or the jury where one is impaneled, must apply the preponderance of evidence test by determining which side has the greater weight of credible, relevant evidence.

Adjudication and the adversary system imply certain other characteristics of courts. Judges must be impartial; those with a personal interest in a matter must refuse to hear it. The ruling of a court, after all appeals are exhausted, is final. This principle is known as res judicata (Latin for "the thing is decided"), and it means that the same parties may not take up the same dispute in another court at another time. Finally, a court must proceed according to a public set of formal procedural rules; a judge cannot make up the rules as she goes along. To these rules we now turn.

How a Case Proceeds

Complaint and Summons

Beginning a lawsuit is simple and is spelled out in the rules of procedure by which each court system operates. In the federal system, the plaintiff begins a lawsuit by filing a complaint—a document clearly explaining the grounds for suit—with the clerk of the court. The court's agent (usually a sheriff, for state trial courts, or a US deputy marshal, in federal district courts) will then serve the defendant with the complaint and a summons. The summons is a court document stating the name of the plaintiff and his attorney and directing the defendant to respond to the complaint within a fixed time period.

The timing of the filing can be important. Almost every possible legal complaint is governed by a federal or state statute of limitations, which requires a lawsuit to be filed within a certain period of time. For example, in many states a lawsuit for injuries resulting from an automobile accident must be filed within two years of the accident or the plaintiff forfeits his right to proceed. As noted earlier, making a correct initial filing in a court that has subject matter jurisdiction is critical to avoiding statute of limitations problems.

Jurisdiction and Venue

The place of filing is equally important, and there are two issues regarding location. The first is subject matter jurisdiction, as already noted. A claim for breach of contract, in which the amount at stake is $1 million, cannot be brought in a local county court with jurisdiction to hear cases involving sums of up to only $1,000. Likewise, a claim for copyright violation cannot be brought in a state superior court, since federal courts have exclusive jurisdiction over copyright cases.

The second consideration is venue—the proper geographic location of the court. For example, every county in a state might have a superior court, but the plaintiff is not free to pick any county. Again, a statute will spell out to which court the plaintiff must go (e.g., the county in which the plaintiff resides or the county in which the defendant resides or maintains an office).

Service of Process and Personal Jurisdiction

The defendant must be "served"—that is, must receive notice that he has been sued. Service can be done by physically presenting the defendant with a copy of the summons and complaint. But sometimes the defendant is difficult to find (or deliberately avoids the marshal or other process server). The rules spell out a variety of ways by which individuals and corporations can be served. These include using US Postal Service certified mail or serving someone already designated to receive service of process. A corporation or partnership, for example, is often required by state law to designate a "registered agent" for purposes of getting public notices or receiving a summons and complaint.

One of the most troublesome problems is service on an out-of-state defendant. The personal jurisdiction of a state court over persons is clear for those defendants found within the state. If the plaintiff claims that an out-of-state defendant injured him in some way, must the plaintiff go to the defendant's home state to serve him? Unless the defendant had some significant contact with the plaintiff's state, the plaintiff may indeed have to. For instance, suppose a traveler from Maine stopped at a roadside diner in

Montana and ordered a slice of homemade pie that was tainted and caused him to be sick. The traveler may not simply return home and mail the diner a notice that he is suing it in a Maine court. But if out-of-state defendants have some contact with the plaintiff's state of residence, there might be grounds to bring them within the jurisdiction of the plaintiff's state courts. In *Burger King v. Rudzewicz*, Section 3.9, the federal court in Florida had to consider whether it was constitutionally permissible to exercise personal jurisdiction over a Michigan franchisee.

Again, recall that even if a court has subject matter jurisdiction, it must also have personal jurisdiction over each defendant against whom an enforceable judgment can be made. Often this is not a problem; you might be suing a person who lives in your state or regularly does business in your state. Or a nonresident may answer your complaint without objecting to the court's "in personam" (personal) jurisdiction. But many defendants who do not reside in the state where the lawsuit is filed would rather not be put to the inconvenience of contesting a lawsuit in a distant forum. Fairness—and the due process clause of the Fourteenth Amendment—dictates that nonresidents should not be required to defend lawsuits far from their home base, especially where there is little or no contact or connection between the nonresident and the state where a lawsuit is brought.

Summary of Rules on Personal Jurisdiction

1. Once a court determines that it has subject matter jurisdiction, it must find at least one defendant over which it is "fair" (i.e., in accord with due process) to exercise personal jurisdiction.
2. If a plaintiff sues five defendants and the court has personal jurisdiction over just one, the case can be heard, but the court cannot make a judgment against the other four. This involves the principle of res judicata, which means that you can't bring the same action against the same person (or entity) twice. It's like the civil side of double jeopardy. *Res* means "thing," and *judicata* means "adjudicated." Thus the "thing" has been "adjudicated" and should not be judged again. But, as to nonparticipating parties, it is not over. If you have a *different* case against the same defendant—one that arises out of a completely different situation—that case is not barred by res judicata.But if the plaintiff loses against defendant 1, he can go elsewhere (to another state or states) and sue defendants 2, 3, 4, or 5. The court's decision in the first lawsuit (against defendant 1) does not determine the liability of the nonparticipating defendants.
3. Service of process is a necessary (but not sufficient) condition for getting personal jurisdiction over a particular defendant (see rule 4). In order to get a judgment in a civil action, the plaintiff must serve a copy of the complaint and a summons on the defendant. There are many ways to do this.
    - The process server personally serves a complaint on the defendant.
    - The process server leaves a copy of the summons and complaint at the residence of the defendant, in the hands of a competent person.
    - The process server sends the summons and complaint by certified mail, return receipt requested.
    - The process server, if all other means are not possible, notifies the defendant by publication in a newspaper having a minimum number of readers (as may be specified by law).
4. In addition to successfully serving the defendant with process, a plaintiff must convince the court that exercising personal jurisdiction over the defendant is consistent with due process and any statutes in that state that prescribe the jurisdictional reach of that state (the so-called long-arm statutes). The Supreme Court has long recognized various bases for judging whether such process is fair.
    - Consent. The defendant agrees to the court's jurisdiction by coming to court, answering the complaint, and having the matter litigated there.
    - Domicile. The defendant is a permanent resident of that state.
    - Event. The defendant did something in that state, related to the lawsuit, that makes it fair for the state to say, "Come back and defend!"
    - Service of process within the state will effectively provide personal jurisdiction over the nonresident.

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

the court must consider whether it is fair to require an out-of-state defendant to appear and defend against a lawsuit that could result in a judgment against that defendant.

Almost every state in the United States has a statute regarding personal jurisdiction, instructing judges when it is permissible to assert personal jurisdiction over an out-of-state resident. These are called long-arm statutes. But no state can reach out beyond the limits of what is constitutionally permissible under the Fourteenth Amendment, which binds the states with its proviso to guarantee the due process rights of the citizens of every state in the union. The "minimum contacts" test in *Burger King v. Rudzewicz* (Section 3.9) tries to make the fairness mandate of the due process clause more specific. So do other tests articulated in the case (such as "does not offend traditional notions of fair play and substantial justice"). These tests are posed by the Supreme Court and heeded by all lower courts in order to honor the provisions of the Fourteenth Amendment's due process guarantees. These tests are *in addition to* any state long-arm statute's instructions to courts regarding the assertion of personal jurisdiction over nonresidents.

Choice of Law and Choice of Forum Clauses

In a series of cases, the Supreme Court has made clear that it will honor contractual choices of parties in a lawsuit. Suppose the parties to a contract wind up in court arguing over the application of the contract's terms. If the parties are from two different states, the judge may have difficulty determining which law to apply (see Table 3.1). But if the contract says that a particular state's law will be applied if there is a dispute, then ordinarily the judge will apply that state's law as a rule of decision in the case. For example, Kumar Patel (a Missouri resident) opens a brokerage account with Goldman, Sachs and Co., and the contractual agreement calls for "any disputes arising under this agreement" to be determined "according to the laws of the state of New York." When Kumar claims in a Missouri court that his broker is "churning" his account, and, on the other hand, Goldman, Sachs claims that Kumar has failed to meet his margin call and owes $38,568.25 (plus interest and attorney's fees), the judge in Missouri will apply New York law based on the contract between Kumar and Goldman, Sachs.

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

Key Takeaway

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

Exercises

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

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

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3.4: Motions and Discovery

Learning Objectives

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

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

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

Initial Pleadings, and Motions to Dismiss

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

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

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

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

Discovery

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

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

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

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

Key Takeaway

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

Exercises

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

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3.5: The Pretrial and Trial Phase

Learning Objectives

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

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

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

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

Pretrial Conference

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

Trial

At trial, the first order of business is to select a jury. In a civil case of any consequence, either party can request one, based on the Sixth Amendment to the US Constitution. The judge and sometimes the lawyers are permitted to question the jurors to be sure that they are unbiased. This questioning is known as the voir dire (pronounced vwahr-DEER). This is an important process, and a great deal of thought goes into selecting the jury, especially in high-profile cases. A jury panel can be as few as six persons, or as many as twelve, with alternates selected and sitting in court in case one of the jurors is unable to continue. In a long trial, having alternates is essential; even in shorter trials, most courts will have at least two alternate jurors.

In both criminal and civil trials, each side has opportunities to challenge potential jurors for cause. For example, in the Robinsons’ case against Audi, the attorneys representing Audi will want to know if any prospective jurors have ever owned an Audi, what their experience has been, and if they had a similar problem (or worse) with their Audi that was not resolved to their satisfaction. If so, the defense attorney could well believe that such a juror has a potential for a bias against her client. In that case, she could use a challenge for cause, explaining to the judge the basis for her challenge. The judge, at her discretion, could either accept the for-cause reason or reject it.

Even if an attorney cannot articulate a for-cause reason acceptable to the judge, he may use one of several peremptory challenges that most states (and the federal system) allow. A trial attorney with many years of experience may have a sixth sense about a potential juror and, in consultation with the client, may decide to use a peremptory challenge to avoid having that juror on the panel.

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

The plaintiff’s lawyer then calls witnesses and presents the physical evidence that is relevant to her proof. The direct testimony at trial is usually far from a smooth narration. The rules of evidence (that govern the kinds of testimony and documents that may be

introduced at trial) and the question-and-answer format tend to make the presentation of evidence choppy and difficult to follow.

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

After direct testimony of each witness is over, the opposing lawyer may conduct cross-examination. This is a crucial constitutional right; in criminal cases it is preserved in the Constitution's Sixth Amendment (the right to confront one's accusers in open court). The formal rules of direct testimony are then relaxed, and the cross-examiner may probe the witness more informally, asking questions that may not seem immediately relevant. This is when the opposing attorney may become harsh, casting doubt on a witness's credibility, trying to trip her up and show that the answers she gave are false or not to be trusted. This use of cross-examination, along with the requirement that the witness must respond to questions that are at all relevant to the questions raised by the case, distinguishes common-law courts from those of authoritarian regimes around the world.

Following cross-examination, the plaintiff's lawyer may then question the witness again: this is called redirect examination and is used to demonstrate that the witness's original answers were accurate and to show that any implications otherwise, suggested by the cross-examiner, were unwarranted. The cross-examiner may then engage the witness in re-cross-examination, and so on. The process usually stops after cross-examination or redirect.

During the trial, the judge's chief responsibility is to see that the trial is fair to both sides. One big piece of that responsibility is to rule on the admissibility of evidence. A judge may rule that a particular question is out of order—that is, not relevant or appropriate—or that a given document is irrelevant. Where the attorney is convinced that a particular witness, a particular question, or a particular document (or part thereof) is critical to her case, she may preserve an objection to the court's ruling by saying "exception," in which case the court stenographer will note the exception; on appeal, the attorney may cite any number of exceptions as adding up to the lack of a fair trial for her client and may request a court of appeals to order a retrial.

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

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

When all testimony has been introduced, either party may ask the judge for a directed verdict—a verdict decided by the judge without advice from the jury. This motion may be granted if the plaintiff has failed to introduce evidence that is legally sufficient to meet her burden of proof or if the defendant has failed to do the same on issues on which she has the burden of proof. (For example, the plaintiff alleges that the defendant owes him money and introduces a signed promissory note. The defendant cannot show that the note is invalid. The defendant must lose the case unless he can show that the debt has been paid or otherwise discharged.)

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

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

After closing arguments, the judge will instruct the jury. The purpose of jury instruction is to explain to the jurors the meaning of the law as it relates to the issues they are considering and to tell the jurors what facts they must determine if they are to give a verdict for one party or the other. Each lawyer will have prepared a set of written instructions that she hopes the judge will give to the jury. These will be tailored to advance her client's case. Many a verdict has been overturned on appeal because a trial judge has wrongly instructed the jury. The judge will carefully determine which instructions to give and often will use a set of pattern instructions provided by the state bar association or the supreme court of the state. These pattern jury instructions are often safer

because they are patterned after language that appellate courts have used previously, and appellate courts are less likely to find reversible error in the instructions.

After all instructions are given, the jury will retire to a private room and discuss the case and the answers requested by the judge for as long as it takes to reach a unanimous verdict. Some minor cases do not require a unanimous verdict. If the jury cannot reach a decision, this is called a hung jury, and the case will have to be retried. When a jury does reach a verdict, it delivers it in court with both parties and their lawyers present. The jury is then discharged, and control over the case returns to the judge. (If there is no jury, the judge will usually announce in a written opinion his findings of fact and how the law applies to those facts. Juries just announce their verdicts and do not state their reasons for reaching them.)

Posttrial Motions

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

Key Takeaway

The purpose of a trial judge is to ensure justice to all parties to the lawsuit. The judge presides, instructs the jury, and may limit who testifies and what they testify about what. In all of this, the judge will usually commit some errors; occasionally these will be the kinds of errors that seriously compromise a fair trial for both parties. Errors that do seriously compromise a fair trial for both parties are prejudicial, as opposed to harmless. The appeals court must decide whether any errors of the trial court judge are prejudicial or not.

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

Exercises

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

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3.6: Judgment, Appeal, and Execution

Learning Objectives

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

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

Judgment or Order

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

Appeal

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

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

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

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

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

state. But a supreme court in one state with a type of case it has not previously dealt with may find persuasive reasoning in decisions of other state supreme courts.

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

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

Judgment and Order

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

Key Takeaway

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

Exercises

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

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3.7: When Can Someone Bring a Lawsuit?

Learning Objectives

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

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

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

Case or Controversy: Standing to Sue

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

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

The standing doctrine is easy to understand in straightforward cases such as this but is often a fairly complicated matter. For example, can fifteen or more state attorneys general bring a lawsuit for a declaratory judgment that health care legislation passed in 2025 is unconstitutional? What particular injury have they (or the states) suffered? Are they the best set of plaintiffs to raise this issue? Time—and the Supreme Court—will tell.

Class Actions

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

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

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

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

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

Key Takeaway

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

Exercises

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

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3.8: Relations with Lawyers

Learning Objectives

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

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

Legal Fees

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

Lawyers generally charge by the hour for courtroom time and for ongoing representation in commercial matters. Virtually every sizable law firm bills its clients by hourly rates, which in large cities can range from $400 for an associate's time to $1000 and more for a senior partner's time.

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

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

Costs

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

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

Key Takeaway

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

Exercises

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

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

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3.9: Alternative Means of Resolving Disputes

Learning Objectives

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

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

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

Our legal system relies on parties resolving their disputes in ways other than adjudication in the courts--there are not enough courtrooms, judges, and court resources to try every case brought to court. Beginning around 1980, a movement toward alternative dispute resolution began to gain force throughout the United States. Bar associations, other private groups, and the courts themselves wanted to find quicker and cheaper ways for litigants and potential litigants to settle certain types of quarrels than through the courts. As a result, neighborhood justice centers or dispute resolution centers have sprung up in communities. These are where people can come for help in settling disputes, of both civil and criminal nature, that should not consume the time and money of the parties or courts in lengthy proceedings.

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

Negotiation

People frequently resolve conflicts or differences without filing lawsuits. Whether it is a dispute over what to watch on television or whether a refund should be issued for a product purchased at a store, people talk, compromise, and find resolutions to their problems in the ordinary course of their affairs. Some disputes, however, that are not resolved find their way into court for adjudication. Nonetheless, those disputes remain subject to resolution by people discussing their differences and resolving them without the intervention of third parties such as judges, mediators, or arbitrators. That is, the parties can negotiate a resolution of their disputes. Negotiation has been defined as a, "back-and-forth communication designed to reach an agreement when you and the other side have some interests that are shared and others that are opposed." (Fisher, Ury, and Patton, *Getting to Yes*, Penguin Books, 1991.) Parties, often through their lawyers, negotiate settlements of their cases in a overwhelming majority of civil cases. Negotiation is also the primary method for resolving criminal cases. Most criminal complaints are resolved after the prosecutor and defense attorney negotiate a "please agreement" wherein the defendant pleads guilty to a charge in exchange for the dismissal of additional or more serious charges or the reduction in sanctions (such as jail time).

Mediation

Sometimes, the circumstances are not right for the parties to reach a resolution on their own. Perhaps there is too much emotion between them to have productive talks. Maybe they do not have the experience in an area to know what potential solutions might be available to resolve their dispute. In these cases, a neutral third party--called a "mediator"--can facilitate a resolution for the parties. The mediator is a go-between who attempts to help the parties negotiate a solution. The mediator, in a process called mediation, will communicate the parties' positions to each other, will facilitate the finding of common ground, and will suggest outcomes. But the parties have complete control: they may ignore the recommendations of the mediator entirely, settle in their own way, find another mediator, agree to binding arbitration, go to court, or forget the whole thing! Mediation gives the neutral party no power to impose a decision.

Arbitration

Arbitration, however, is a type of adjudication where the parties choose to use a private decision maker, the arbitrator, to resolve their dispute through the imposition of a decision. The rules of procedure are considerably more relaxed than those that apply in the courtroom. Arbitrators might be retired judges, lawyers, or anyone with the kind of specialized knowledge and training that would be useful in making a final, binding decision on the dispute. In a contractual relationship, the parties can decide even before a dispute arises to use arbitration when the time comes. Or parties can decide after a dispute arises to use arbitration instead of litigation. In a predispute arbitration agreement (often part of a larger contract), the parties can spell out the rules of procedure to be used and the method for choosing the arbitrator. For example, they may name the specific person or delegate the responsibility of choosing to some neutral person, or they may each designate a person and the two designees may jointly pick a third arbitrator.

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

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

Under both federal and state law, arbitration is favored, and a decision rendered by an arbitrator is binding by law and may be enforced by the courts. The arbitrator's decision is final and binding, with very few exceptions (such as fraud or manifest disregard of the law by the arbitrator or panel of arbitrators). Saying that arbitration is favored means that if you have agreed to arbitration, you can't go to court if the other party wants you to arbitrate. Under the Federal Arbitration Act, the other party can go to court and get a stay against your litigation and also get an order compelling you to go to arbitration.

Key Takeaway

Litigation is not the only way to resolve disputes. Informal negotiation between the disputants usually comes first, but both mediation and arbitration are available. Arbitration, though, is final and binding. Once you agree to arbitrate, you will have a final, binding arbitral award that is enforceable through the courts, and courts will almost never allow you to litigate after you have agreed to arbitrate.

Exercises

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

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CHAPTER OVERVIEW

4: Constitutional Law and US Commerce

Learning Objectives

After reading this chapter, you should understand the following:

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

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

4.1: Basic Aspects of the US Constitution

4.2: The Commerce Clause

4.3: Dormant Commerce Clause

4.4: Preemption- The Supremacy Clause

4.5: Business and the Bill of Rights

4.6: Summary and Exercises

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4.1: Basic Aspects of the US Constitution

Learning Objectives

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

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

The Constitution as Reflecting American Values

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

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

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

General Structure of the Constitution

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

Federalism

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

Separation of Powers and Judicial Review

Because the Founding Fathers wanted to ensure that no single branch of the government, especially the executive branch, would be ascendant over the others, they created various checks and balances to ensure that each of the three principal branches had ways to limit or modify the power of the others. This is known as the separation of powers. Thus the president retains veto power, but the House of Representatives is entrusted with the power to initiate spending bills.

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

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

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

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

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

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

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

In a rare move, in *Dobbs v. Jackson Women's Health Organization*, 597 U.S. 215 (2022), the US Supreme Court reversed its *Roe v. Wade* opinion. The majority opinion in Dobbs, written by Associate Justice Samuel Alito, stated, "*Roe* was egregiously wrong from the start." The court held abortion was not among the legally recognizable rights that are "deeply rooted in this Nation's history and tradition."

The *Griswold*, *Roe*, and *Dobbs cases* demonstrate the enormous power Supreme Court justices wield when interpreting the Constitution. In deciding that the right of privacy applied to a woman's decision to abort in the first trimester, the Supreme Court did not act on the basis of a popular mandate or clear and unequivocal language in the Constitution, and it made illegal any state or federal legislative or executive action contrary to its interpretation. Only a constitutional amendment or the court's repudiation of *Roe* as a precedent could change that interpretation. In *Dob*bs, the Supreme Court exercised its discretion to change its interpretation of the Constitution.

Key Takeaway

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

Exercises

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

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4.2: The Commerce Clause

Learning Objectives

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

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

First, turn to Article I, Section 8 of the US Constitution. The commerce clause gives Congress the exclusive power to make laws relating to foreign trade and commerce and to commerce among the various states. Most of the federally created legal environment springs from this one clause: if Congress is not authorized in the Constitution to make certain laws, then it acts unconstitutionally and its actions may be ruled unconstitutional by the Supreme Court. Lately, the Supreme Court has not been shy about ruling acts of Congress unconstitutional.

Here are the first five parts of Article I, Section 8, which sets forth the powers of the federal legislature. The commerce clause is in boldface. It is short, but most federal legislation affecting business depends on this very clause:

Section 8

[Clause 1] The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States;

[Clause 2] To borrow Money on the credit of the United States;

[Clause 3] To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes;

[Clause 4] To establish a uniform Rule of Naturalization, and uniform Laws on the subject of Bankruptcies throughout the United States;

[Clause 5] To coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures;

Early Commerce Clause Cases

For many years, the Supreme Court was very strict in applying the commerce clause: Congress could only use it to legislate aspects of the movement of goods from one state to another. Anything else was deemed local rather than national. For example, In *Hammer v. Dagenhart*, decided in 1918, a 1916 federal statute had barred transportation in interstate commerce of goods produced in mines or factories employing children under fourteen or employing children fourteen and above for more than eight hours a day. A complaint was filed in the US District Court for the Western District of North Carolina by a father in his own behalf and on behalf of his two minor sons, one under the age of fourteen years and the other between fourteen and sixteen years, who were employees in a cotton mill in Charlotte, North Carolina. The father's lawsuit asked the court to enjoin (block) the enforcement of the act of Congress intended to prevent interstate commerce in the products of child labor.

The Supreme Court saw the issue as whether Congress had the power under the commerce clause to control interstate shipment of goods made by children under the age of fourteen. The court found that Congress did not. The court cited several cases that had considered what interstate commerce could be constitutionally regulated by Congress. In *Hipolite Egg Co. v. United States*, the Supreme Court had sustained the power of Congress to pass the Pure Food and Drug Act, which prohibited the introduction into the states by means of interstate commerce impure foods and drugs.*Hipolite Egg Co. v. United States*, 220 US 45 (1911). In *Hoke v. United States*, the Supreme Court had sustained the constitutionality of the so-called White Slave Traffic Act of 1910, whereby the transportation of a woman in interstate commerce for the purpose of prostitution was forbidden. In that case, the court said that Congress had the power to protect the channels of interstate commerce: "If the facility of interstate transportation can be taken

away from the demoralization of lotteries, the debasement of obscene literature, the contagion of diseased cattle or persons, the impurity of food and drugs, the like facility can be taken away from the systematic enticement to, and the enslavement in prostitution and debauchery of women, and, more insistently, of girls." (*Hoke v. United States*, 227 US 308 (1913).)

In each of those instances, the Supreme Court said, "[T]he use of interstate transportation was necessary to the accomplishment of harmful results." In other words, although the power over interstate transportation was to regulate, that could only be accomplished by prohibiting the use of the facilities of interstate commerce to effect the evil intended. But in *Hammer v. Dagenhart*, that essential element was lacking. The law passed by Congress aimed to standardize among all the states the ages at which children could be employed in mining and manufacturing, while the goods themselves are harmless. Once the labor is done and the articles have left the factory, the "labor of their production is over, and the mere fact that they were intended for interstate commerce transportation does not make their production subject to federal control under the commerce power."

In short, the early use of the commerce clause was limited to the movement of physical goods between states. Just because something might enter the channels of interstate commerce later on does not make it a fit subject for national regulation. The production of articles intended for interstate commerce is a matter of local regulation. The court therefore upheld the result from the district and circuit court of appeals; the application of the federal law was enjoined. Goods produced by children under the age of fourteen could be shipped anywhere in the United States without violating the federal law.

From the New Deal to the New Frontier and the Great Society:1930s–1970

During the global depression of the 1930s, the US economy saw jobless rates of a third of all workers, and President Roosevelt's New Deal program required more active federal legislation. Included in the New Deal program was the recognition of a "right" to form labor unions without undue interference from employers. Congress created the National Labor Relations Board (NLRB) in 1935 to investigate and to enjoin employer practices that violated this right.

In *NLRB v. Jones & Laughlin Steel Corporation*, a union dispute with management at a large steel-producing facility near Pittsburgh, Pennsylvania, became a court case. In this case, the NLRB had charged the Jones & Laughlin Steel Corporation with discriminating against employees who were union members. The company's position was that the law authorizing the NLRB was unconstitutional, exceeding Congress's powers. The court held that the act was narrowly constructed so as to regulate industrial activities that had the potential to restrict interstate commerce. The earlier decisions under the commerce clause to the effect that labor relations had only an indirect effect on commerce were effectively reversed. Since the ability of employees to engage in collective bargaining (one activity protected by the act) is "an essential condition of industrial peace," the national government was justified in penalizing corporations engaging in interstate commerce that "refuse to confer and negotiate" with their workers. This was, however, a close decision, and the switch of one justice made this ruling possible. Without this switch, the New Deal agenda would have been effectively derailed.

The Substantial Effects Doctrine: World War II to the 1990s

Subsequent to *NLRB v. Jones & Laughlin Steel Corporation*, Congress and the courts generally accepted that even modest impacts on interstate commerce were "reachable" by federal legislation. For example, the case of *Wickard v. Filburn*, from 1942, represents a fairly long reach for Congress in regulating what appear to be very local economic decisions (Section 4.6.2).

Wickard established that "substantial effects" in interstate commerce could be very local indeed! But commerce clause challenges to federal legislation continued. In the 1960s, the Civil Rights Act of 1964 was challenged on the ground that Congress lacked the power under the commerce clause to regulate what was otherwise fairly local conduct. For example, Title II of the act prohibited racial discrimination in public accommodations (such as hotels, motels, and restaurants), leading to the famous case of *Katzenbach v. McClung* (1964).

Ollie McClung's barbeque place in Birmingham, Alabama, allowed "colored" people to buy takeout at the back of the restaurant but not to sit down with "white" folks inside. The US attorney sought a court order to require Ollie to serve all races and colors, but Ollie resisted on commerce clause grounds: the federal government had no business regulating a purely local establishment. Indeed, Ollie did not advertise nationally, or even regionally, and had customers only from the local area. But the court found that some 42 percent of the supplies for Ollie's restaurant had moved in the channels of interstate commerce. This was enough to sustain federal regulation based on the commerce clause.

For nearly thirty years following, it was widely assumed that Congress could almost always find some interstate commerce connection for any law it might pass. It thus came as something of a shock in 1995 when the Rehnquist court decided *U.S. v. Lopez*. Lopez had been convicted under a federal law that prohibited possession of firearms within 1,000 feet of a school. The law was part of a twenty-year trend (roughly 1970 to 1990) for senators and congressmen to pass laws that were tough on crime. Lopez's lawyer admitted that Lopez had had a gun within 1,000 feet of a San Antonio school yard but challenged the law itself, arguing that Congress exceeded its authority under the commerce clause in passing this legislation. The US government's Solicitor General argued on behalf of the Department of Justice to the Supreme Court that Congress was within its constitutional rights under the commerce clause because education of the future workforce was the foundation for a sound economy and because guns at or near school yards detracted from students' education. The court rejected this analysis, noting that with the government's analysis, an interstate commerce connection could be conjured from almost anything. Lopez went free because the law itself was unconstitutional, according to the court.

Congress made no attempt to pass similar legislation after the case was decided. But in passing subsequent legislation, Congress was often careful to make a record as to why it believed it was addressing a problem that related to interstate commerce. In 1994, Congress passed the Violence Against Women Act (VAWA), having held hearings to establish why violence against women on a local level would impair interstate commerce. In 1994, while enrolled at Virginia Polytechnic Institute (Virginia Tech), Christy Brzonkala alleged that Antonio Morrison and James Crawford, both students and varsity football players at Virginia Tech, had raped her. In 1995, Brzonkala filed a complaint against Morrison and Crawford under Virginia Tech's sexual assault policy. After a hearing, Morrison was found guilty of sexual assault and sentenced to immediate suspension for two semesters. Crawford was not punished. A second hearing again found Morrison guilty. After an appeal through the university's administrative system, Morrison's punishment was set aside, as it was found to be "excessive." Ultimately, Brzonkala dropped out of the university. Brzonkala then sued Morrison, Crawford, and Virginia Tech in federal district court, alleging that Morrison's and Crawford's attack violated 42 USC Section 13981, part of the VAWA), which provides a federal civil remedy for the victims of gender-motivated violence. Morrison and Crawford moved to dismiss Brzonkala's suit on the ground that Section 13981's civil remedy was unconstitutional. In dismissing the complaint, the district court found that that Congress lacked authority to enact Section 13981 under either the commerce clause or the Fourteenth Amendment, which Congress had explicitly identified as the sources of federal authority for the VAWA. Ultimately, the court of appeals affirmed, as did the Supreme Court.

The Supreme Court held that Congress lacked the authority to enact a statute under the commerce clause or the Fourteenth Amendment because the statute did not regulate an activity that substantially affected interstate commerce nor did it redress harm caused by the state. Chief Justice William H. Rehnquist wrote for the court that "under our federal system that remedy must be provided by the Commonwealth of Virginia, and not by the United States." Dissenting, Justice Stephen G. Breyer argued that the majority opinion "illustrates the difficulty of finding a workable judicial Commerce Clause touchstone." Justice David H. Souter, dissenting, noted that VAWA contained a "mountain of data assembled by Congress…showing the effects of violence against women on interstate commerce."

The absence of a workable judicial commerce clause touchstone remains. In 1996, California voters passed the Compassionate Use Act, legalizing marijuana for medical use. California's law conflicted with the federal Controlled Substances Act (CSA), which banned possession of marijuana. After the Drug Enforcement Administration (DEA) seized doctor-prescribed marijuana from a patient's home, a group of medical marijuana users sued the DEA and US Attorney General John Ashcroft in federal district court.

The medical marijuana users argued that the CSA—which Congress passed using its constitutional power to regulate interstate commerce—exceeded Congress's commerce clause power. The district court ruled against the group, but the Ninth Circuit Court of Appeals reversed and ruled the CSA unconstitutional because it applied to medical marijuana use solely within one state. In doing so, the Ninth Circuit relied on *U.S. v. Lopez* (1995) and *U.S. v. Morrison* (2000) to say that using medical marijuana did not "substantially affect" interstate commerce and therefore could not be regulated by Congress.

But by a 6–3 majority, the Supreme Court held that the commerce clause gave Congress authority to prohibit the local cultivation and use of marijuana, despite state law to the contrary. Justice John Paul Stevens argued that the court's precedents established Congress's commerce clause power to regulate purely local activities that are part of a "class of activities" with a substantial effect on interstate commerce. The majority argued that Congress could ban local marijuana use because it was part of such a class of activities: the national marijuana market. Local use affected supply and demand in the national marijuana market, making the regulation of intrastate use "essential" to regulating the drug's national market.

Notice how similar this reasoning is to the court's earlier reasoning in *Wickard v. Filburn* (Section 4.6.2). In contrast, the court's conservative wing was adamant that federal power had been exceeded. Justice Clarence Thomas's dissent in *Gonzalez v. Raich* stated that Raich's local cultivation and consumption of marijuana was not "Commerce…among the several States." Representing the "originalist" view that the Constitution should mostly mean what the Founders meant it to mean, he also said that in the early days of the republic, it would have been unthinkable that Congress could prohibit the local cultivation, possession, and consumption of marijuana.

Key Takeaway

The commerce clause is the basis on which the federal government regulates interstate economic activity. The phrase "interstate commerce" has been subject to differing interpretations by the Supreme Court over the past one hundred years. There are certain matters that are essentially local or intrastate, but the range of federal involvement in local matters is still considerable.

Exercises

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

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4.3: Dormant Commerce Clause

Learning Objectives

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

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

Congress has the power to legislate under the commerce clause and often does legislate. For example, Congress might say that trucks moving on interstate highways must not be more than seventy feet in length. But if Congress does not exercise its powers and regulate in certain areas (such as the size and length of trucks on interstate highways), states may make their own rules. States may do so under the so-called historic police powers of states that were never yielded up to the federal government.

These police powers can be broadly exercised by states for purposes of health, education, welfare, safety, morals, and the environment. But the Supreme Court has reserved for itself the power to determine when state action is excessive, even when Congress has not used the commerce clause to regulate. This power is claimed to exist in the dormant commerce clause.

There are two ways that a state may violate the dormant commerce clause. If a state passes a law that is an "undue burden" on interstate commerce or that "discriminates" against interstate commerce, it will be struck down. *Kassel v. Consolidated Freightways*, in Section 4.7, is an example of a case where Iowa imposed an undue burden on interstate commerce by prohibiting double trailers on its highways. *Kassell v. Consolidated Freightways*, 450 US 662 (1981). Iowa's prohibition was judicially declared void when the Supreme Court judged it to be an undue burden. But, determining what constitutes an undue burden is situational. For instance, in *National Pork Producers Council v. Ross*, 598 U.S. 356 (2023), the US Supreme Court upheld California's Proposition 12, which banned the sale of whole pork meat from pigs that had been "confined in a cruel manner." The fact that California's ban affected non-California pork producers and therefore had some impact on interstate commerce was insufficient to demonstrate an unconstitutional undue burden on such commerce.

Discrimination cases such as *Hunt v. Washington Apple Advertising Commission* (Section 4.6) pose a different standard. The court has been fairly inflexible here: if one state discriminates in its treatment of any article of commerce based on its state of origin, the court will strike down the law. For example, in *Oregon Waste Systems v. Department of Environmental Quality*, the state wanted to place a slightly higher charge on waste coming from out of state. *Oregon Waste Systems v. Department of Environmental Quality*, 511 US 93 (1994). The state's reasoning was that in-state residents had already contributed to roads and other infrastructure and that tipping fees at waste facilities should reflect the prior contributions of in-state companies and residents. Out-of-state waste handlers who wanted to use Oregon landfills objected and won their dormant commerce clause claim that Oregon's law discriminated "on its face" against interstate commerce. Under the Supreme Court's rulings, anything that moves in channels of interstate commerce is "commerce," even if someone is paying to get rid of something instead of buying something.

Thus the states are bound by Supreme Court decisions under the dormant commerce clause to do nothing that differentiates between articles of commerce that originate from within the state from those that originate elsewhere. If Michigan were to let counties decide for themselves whether to take garbage from outside of the county or not, this could also be a discrimination based on a place of origin outside the state. (Suppose, for instance, each county were to decide not to take waste from outside the county; then all Michigan counties would effectively be excluding waste from outside of Michigan, which is discriminatory.) *Fort Gratiot Sanitary Landfill v. Michigan Dep't of Natural Resources*, 504 US 353 (1992).

The Supreme Court probably would uphold any solid waste requirements that did not differentiate on the basis of origin. If, for example, all waste had to be inspected for specific hazards, then the law would apply equally to in-state and out-of-state garbage. Because this is the dormant commerce clause, Congress could still act (i.e., it could use its broad commerce clause powers) to say that states are free to keep out-of-state waste from coming into their own borders. But Congress has declined to do so. What follows is a statement from one of the US senators from Michigan, Carl Levin, in 2003, regarding the significant amounts of waste that were coming into Michigan from Toronto, Canada.

Dealing with Unwelcome Waste

Senator Carl Levin, January 2003

Michigan is facing an intolerable situation with regard to the importation of waste from other states and Canada.

Canada is the largest source of waste imports to Michigan. Approximately 65 truckloads of waste come in to Michigan per day from Toronto alone, and an estimated 110–130 trucks come in from Canada each day.

This problem isn't going to get any better. Ontario's waste shipments are growing as the Toronto area signs new contracts for waste disposal here and closes its two remaining landfills. At the beginning of 1999, the Toronto area was generating about 2.8 million tons of waste annually, about 700,000 tons of which were shipped to Michigan. By early this year, barring unforeseen developments, the entire 2.8 million tons will be shipped to Michigan for disposal.

Why can't Canada dispose of its trash in Canada? They say that after 20 years of searching they have not been able to find a suitable Ontario site for Toronto's garbage. Ontario has about 345,000 square miles compared to Michigan's 57,000 square miles. With six times the land mass, that argument is laughable.

The Michigan Department of Environmental Quality estimates that, for every five years of disposal of Canadian waste at the current usage volume, Michigan is losing a full year of landfill capacity. The environmental impacts on landfills, including groundwater contamination, noise pollution and foul odors, are exacerbated by the significant increase in the use of our landfills from sources outside of Michigan.

I have teamed up with Senator Stabenow and Congressman Dingell to introduce legislation that would strengthen our ability to stop shipments of waste from Canada.

We have protections contained in a 17 year-old international agreement between the U.S. and Canada called the Agreement Concerning the Transboundary Movement of Hazardous Waste. The U.S. and Canada entered into this agreement in 1986 to allow the shipment of hazardous waste across the U.S./Canadian border for treatment, storage or disposal. In 1992, the two countries decided to add municipal solid waste to the agreement. To protect both countries, the agreement requires notification of shipments to the importing country and it also provides that the importing country may withdraw consent for shipments. Both reasons are evidence that these shipments were intended to be limited. However, the agreement's provisions have not been enforced by the United States.

Canada could not export waste to Michigan without the 1986 agreement, but the U.S. has not implemented the provisions that are designed to protect the people of Michigan. Although those of us that introduced this legislation believe that the Environmental Protection Agency has the authority to enforce this agreement, they have not done so. Our bill would require the EPA [Environmental Protection Agency] to enforce the agreement.

In order to protect the health and welfare of the citizens of Michigan and our environment, we must consider the impact of the importation of trash on state and local recycling efforts, landfill capacity, air emissions, road deterioration resulting from increased vehicular traffic and public health and the environment.

Our bill would require the EPA to consider these factors in determining whether to accept imports of trash from Canada. It is my strong view that such a review should lead the EPA to say "no" to the status quo of trash imports.

Key Takeaway

Where Congress does not act pursuant to its commerce clause powers, the states are free to legislate on matters of commerce under their historic police powers. However, the Supreme Court has set limits on such powers. Specifically, states may not impose undue burdens on interstate commerce and may not discriminate against articles in interstate commerce.

Exercises

1. Suppose that the state of New Jersey wishes to limit the amount of hazardous waste that enters into its landfills. The general assembly in New Jersey passes a law that specifically forbids any hazardous waste from entering into the state. All landfills are subject to tight regulations that will allow certain kinds of hazardous wastes originating in New Jersey to be put in New Jersey landfills but that impose significant criminal fines on landfill operators that accept out-of-state hazardous waste. The Baldessari

Brothers Landfill in Linden, New Jersey, is fined for taking hazardous waste from a New York State transporter and appeals that ruling on the basis that New Jersey's law is unconstitutional. What is the result?

2. The state of Arizona determines through its legislature that trains passing through the state cannot be longer than seventy cars. There is some evidence that in Eastern US states longer trains pose some safety hazards. There is less evidence that long trains are a problem in Western states. Several major railroads find the Arizona legislation costly and burdensome and challenge the legislation after applied-for permits for longer trains are denied. What kind of dormant commerce clause challenge is this, and what would it take for the challenge to be successful?

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4.4: Preemption- The Supremacy Clause

Learning Objectives

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

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

When Congress does use its power under the commerce clause, it can expressly state that it wishes to have exclusive regulatory authority. For example, when Congress determined in the 1950s to promote nuclear power ("atoms for peace"), it set up the Nuclear Regulatory Commission and provided a limitation of liability for nuclear power plants in case of a nuclear accident. The states were expressly told to stay out of the business of regulating nuclear power or the movement of nuclear materials. Thus Rochester, Minnesota, or Berkeley, California, could declare itself a nuclear-free zone, but the federal government would have preempted such legislation. If Michigan wished to set safety standards at Detroit Edison's Fermi II nuclear reactor that were more stringent than the federal Nuclear Regulatory Commission's standards, Michigan's standards would be preempted and thus be void.

Even where Congress does not expressly preempt state action, such action may be impliedly pre-empted. States cannot constitutionally pass laws that interfere with the accomplishment of the purposes of the federal law. Suppose, for example, that Congress passes a comprehensive law that sets standards for foreign vessels to enter the navigable waters and ports of the United States. If a state creates a law that sets standards that conflict with the federal law or sets standards so burdensome that they interfere with federal law, the doctrine of **preemption** will (in accordance with the supremacy clause) void the state law or whatever parts of it are inconsistent with federal law.

But Congress can allow what might appear to be inconsistencies; the existence of federal statutory standards does not always mean that local and state standards cannot be more stringent. If California wants cleaner air or water than other states, it can set stricter standards—nothing in the Clean Water Act or Clean Air Act forbids the state from setting stricter pollution standards. As the auto industry well knows, California has set stricter standards for auto emissions. Since the 1980s, most automakers have made both a federal car and a California car, because federal Clean Air Act emissions restrictions do not preempt more rigorous state standards. In some cases, manufacturers modified their national standards to meet California standards to ensure its products could be sold nationwide. Legislation relating to the use of electric cars will be the next test for businesses in meeting the stricter demands of individual states.

Large industries and companies actually prefer regulation at the national level. It is easier for a large company or industry association to lobby in Washington, DC, than to lobby in fifty different states. Accordingly, industry often asks Congress to put preemptive language into its statutes. The tobacco industry is a case in point. The cigarette warning legislation of the 1960s (where the federal government required warning labels on cigarette packages) effectively preempted state negligence claims based on failure to warn. When the family of a lifetime smoker who had died sued in New Jersey court, one cause of action was the company's failure to warn of the dangers of its product. The Supreme Court reversed the jury's award based on the federal preemption of failure to warn claims under state law.*Cippolone v. Liggett Group*, 505 US 504 (1993).

The Supremacy Clause

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

The preemption doctrine derives from the supremacy clause of the Constitution, which states that the "Constitution and the Laws of the United States…shall be the supreme Law of the Land…any Thing in the Constitutions or Laws of any State to the Contrary notwithstanding." This means of course, that *any* federal law—even a regulation of a federal agency—would control over *any* conflicting state law.

Preemption can be either express or implied. Some acts are clearly preemptive, such as in 2025 when President Trump signed an executive order establishing a uniform federal set of rules regulating artificial intelligence systems. This action was meant to preempt states from creating a patchwork of individual rules. When Congress chooses to expressly preempt state law, the only question for courts becomes determining whether the challenged state law is one that the federal law is intended to preempt. Implied preemption presents more difficult issues. The court has to look beyond the express language of federal statutes to determine whether Congress has "occupied the field" in which the state is attempting to regulate, or whether a state law directly conflicts with federal law, or whether enforcement of the state law might frustrate federal purposes.

Federal "occupation of the field" occurs, according to the court in *Pennsylvania v. Nelson* (1956), when there is "no room" left for state regulation. Courts are to look to the pervasiveness of the federal scheme of regulation, the federal interest at stake, and the danger of frustration of federal goals in making the determination as to whether a challenged state law can stand.

In *Silkwood v. Kerr-McGee* (1984), the court, voting 5–4, found that a $10 million punitive damages award (in a case litigated by famed attorney Gerry Spence) against a nuclear power plant was not impliedly preempted by federal law. Even though the court had recently held that state regulation of the safety aspects of a federally licensed nuclear power plant was preempted, the court drew a different conclusion with respect to Congress's desire to displace state tort law—even though the tort actions might be premised on a violation of federal safety regulations.

Cipollone v. Liggett Group (1993) was a closely watched case concerning the extent of an express preemption provision in two cigarette labeling laws of the 1960s. The case was a wrongful death action brought against tobacco companies on behalf of Rose Cipollone, a lung cancer victim who had started smoking cigarette in the 1940s. The court considered the preemptive effect on state law of a provision that stated, "No requirement based on smoking and health shall be imposed under state law with respect to the advertising and promotion of cigarettes." The court concluded that several types of state tort actions were preempted by the provision but allowed other types to go forward.

Key Takeaway

In cases of conflicts between state and federal law, federal law will preempt (or control) state law because of the supremacy clause. Preemption can be express or implied. In cases where preemption is implied, the court usually finds that compliance with both state and federal law is not possible or that a federal regulatory scheme is comprehensive (i.e., "occupies the field") and should not be modified by state actions.

Exercises

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

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4.5: Business and the Bill of Rights

Learning Objectives

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

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

We have already seen the Fourteenth Amendment's application in *Burger King v. Rudzewicz* (Section 3.9). In that case, the court considered whether it was constitutionally correct for a court to assert personal jurisdiction over a nonresident. The states cannot constitutionally award a judgment against a nonresident if doing so would offend traditional notions of fair play and substantial justice. Even if the state's long-arm statute would seem to allow such a judgment, other states should not give it full faith and credit (see Article V of the Constitution). In short, a state's long-arm statute cannot confer personal jurisdiction that the state cannot constitutionally claim.

The Bill of Rights (the first ten amendments to the Constitution) was originally meant to apply to federal actions only. During the twentieth century, the court began to apply selected rights to state action as well. So, for example, federal agents were prohibited from using evidence seized in violation of the Fourth Amendment, but state agents were not, until *Mapp v. Ohio* (1960), when the court applied the guarantees (rights) of the Fourth Amendment to state action as well. In this and in similar cases, the Fourteenth Amendment's due process clause was the basis for the court's action. The due process clause commanded that states provide due process in cases affecting the life, liberty, or property of US citizens, and the court saw in this command certain "fundamental guarantees" that states would have to observe. Over the years, most of the important guarantees in the Bill of Rights came to apply to state as well as federal action. The court refers to this process as selective incorporation.

Here are some very basic principles to remember:

1. The guarantees of the Bill of Rights apply *only* to state and federal government action. They do not limit what a company or person in the private sector may do. For example, states may not impose censorship on the media or limit free speech in a way that offends the First Amendment, but your boss (in the private sector) may order you not to talk to the media.
2. In some cases, a private company may be regarded as participating in "state action." For example, a private defense contractor that gets 90 percent of its business from the federal government has been held to be public for purposes of enforcing the constitutional right to free speech (the company had a rule barring its employees from speaking out in public against its corporate position). It has even been argued that public regulation of private activity is sufficient to convert the private into public activity, thus subjecting it to the requirements of due process. But the Supreme Court rejected this extreme view in 1974 when it refused to require private power companies, regulated by the state, to give customers a hearing before cutting off electricity for failure to pay the bill. (*Jackson v. Metropolitan Edison Co.*, 419 US 345 (1974).)
3. States have rights, too. While "states rights" was a battle cry of Southern states before the Civil War, the question of what balance to strike between state sovereignty and federal union has never been simple. In *Kimel v. Florida*, for example, the Supreme Court found in the words of the Eleventh Amendment a basis for declaring that states may not have to obey certain federal statutes.

First Amendment

In part, the First Amendment states that "Congress shall make no law…abridging the freedom of speech, or of the press." The Founding Fathers believed that democracy would work best if people (and the press) could talk or write freely, without governmental interference. But the First Amendment was also not intended to be as absolute as it sounded. Oliver Wendell Holmes's famous dictum that the law does not permit you to shout "Fire!" in a crowded theater has seldom been answered, "But why not?" And no one in 1789 thought that defamation laws (torts for slander and libel) had been made unconstitutional. Moreover, because the apparent purpose of the First Amendment was to make sure that the nation had a continuing, vigorous debate over matters political, political speech has been given the highest level of protection over such other forms of speech as (1) "commercial speech," (2) speech that can and should be limited by reasonable "time, place, and manner" restrictions, or (3) obscene speech.

Because of its higher level of protection, political speech can be false, malicious, mean-spirited, or even a pack of lies. A public official in the United States must be prepared to withstand all kinds of false accusations and cannot succeed in an action for defamation unless the defendant has acted with "malice" and "reckless disregard" of the truth. Public figures, such as CEOs of the largest US banks, must also be prepared to withstand accusations that are false. In any defamation action, truth is a defense, but a defamation action brought by a public figure or public official must prove that the defendant not only has his facts wrong but also lies to the public in a malicious way with reckless disregard of the truth. Celebrities such as Timothee Chalamet or Rihanna, for instance, would have the same burden to go forward with a defamation action. It is for this reason that entertainment gossip magazines write exclusively about public figures, public officials, and celebrities; it is possible to say many things that aren't completely true and still have the protection of the First Amendment.

Political speech is so highly protected that the court has recognized the right of people to support political candidates through campaign contributions and thus promote the particular viewpoints and speech of those candidates. Fearing the influence of money on politics, Congress has from time to time placed limitations on corporate contributions to political campaigns. But the Supreme Court has had mixed reactions over time. Initially, the court recognized the First Amendment right of a corporation to donate money, subject to certain limits. (*Buckley v. Valeo*, 424 US 1 (1976).) In another case, *Austin v. Michigan Chamber of Commerce* 494 U.S. 652 (1990), the Michigan Campaign Finance Act prohibited corporations from using treasury money for independent expenditures to support or oppose candidates in elections for state offices. But a corporation could make such expenditures if it set up an independent fund designated solely for political purposes. The law was passed on the assumption that "the unique legal and economic characteristics of corporations necessitate some regulation of their political expenditures to avoid corruption or the appearance of corruption."

The Michigan Chamber of Commerce wanted to support a candidate for Michigan's House of Representatives by using general funds to sponsor a newspaper advertisement and argued that as a nonprofit organization, it was not really like a business firm. The court disagreed and upheld the Michigan law. Justice Marshall found that the chamber was akin to a business group, given its activities, linkages with community business leaders, and high percentage of members (over 75 percent) that were business corporations. Furthermore, Justice Marshall found that the statute was narrowly crafted and implemented to achieve the important goal of maintaining integrity in the political process. But as you will see in *Citizens United v. Federal Election Commission* (Section 4.6), *Austin* was overruled; corporations are recognized as "persons" with First Amendment political speech rights that cannot be impaired by Congress or the states without some compelling governmental interest with restrictions on those rights that are "narrowly tailored."

Fourth Amendment

The Fourth Amendment says, "all persons shall be secure in their persons, houses, papers, and effects from unreasonable searches and seizures, and no warrants shall issue, but upon probable cause, before a magistrate and upon Oath, specifically describing the persons to be searched and places to be seized."

The court has read the Fourth Amendment to prohibit only those government searches or seizures that are "unreasonable." Because of this, businesses that are in an industry that is "closely regulated" can be searched more frequently and can be searched without a warrant. In one case, an auto parts dealer at a junkyard was charged with receiving stolen auto parts. Part of his defense was to claim that the search that found incriminating evidence was unconstitutional. But the court found the search reasonable, because the dealer was in a "closely regulated industry."

In the 1980s, Dow Chemical objected to an overflight by the US Environmental Protection Agency (EPA). The EPA had rented an airplane to fly over the Midland, Michigan, Dow plant, using an aerial mapping camera to photograph various pipes, ponds, and machinery that were not covered by a roof. Because the court's precedents allowed governmental intrusions into "open fields," the EPA search was ruled constitutional. Because the literal language of the Fourth Amendment protected "persons, houses, papers, and effects," anything searched by the government in "open fields" was reasonable. (The court's opinion suggested that if Dow had really wanted privacy from governmental intrusion, it could have covered the pipes and machinery that were otherwise outside and in open fields.)

Note again that constitutional guarantees like the Fourth Amendment apply to governmental action. Your employer or any private enterprise is not bound by constitutional limits. For example, if drug testing of all employees every week is done by government agency, the employees may have a cause of action to object based on the Fourth Amendment. However, if a private employer

begins the same kind of routine drug testing, employees have no constitutional arguments to make; they can simply leave that employer, or they may pursue whatever statutory or common-law remedies are available.

Fifth Amendment

The Fifth Amendment states, “No person shall be…deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.”

The Fifth Amendment has three principal aspects: procedural due process, the takings clause, and substantive due process. In terms of procedural due process, the amendment prevents government from arbitrarily taking the life of a criminal defendant. In civil lawsuits, it is also constitutionally essential that the proceedings be fair. This is why, for example, the defendant in *Burger King v. Rudzewicz* had a serious constitutional argument, even though he lost.

The takings clause of the Fifth Amendment ensures that the government does not take private property without just compensation. In the international setting, governments that take private property engage in what is called expropriation. The standard under customary international law is that when governments do that, they must provide prompt, adequate, and effective compensation. This does not always happen, especially where foreign owners’ property is being expropriated. The guarantees of the Fifth Amendment (incorporated against state action by the Fourteenth Amendment) are available to property owners where state, county, or municipal government uses the power of eminent domain to take private property for public purposes. Just what is a public purpose is a matter of some debate. For example, if a city were to condemn economically viable businesses or neighborhoods to construct a baseball stadium with public money to entice a private enterprise (the baseball team) to stay, is a public purpose being served?

In *Kelo v. City of New London*, Mrs. Kelo and other residents fought the city of New London, in its attempt to use powers of eminent domain to create an industrial park and recreation area that would have Pfizer & Co. as a principal tenant.*Kelo v. City of New London*, 545 US 469 (2005). The city argued that increasing its tax base was a sufficient public purpose. In a very close decision, the Supreme Court determined that New London’s actions did not violate the takings clause. However, political reactions in various states resulted in a great deal of new state legislation that would limit the scope of public purpose in eminent domain takings and provide additional compensation to property owners in many cases.

In addition to the takings clause and aspects of procedural due process, the Fifth Amendment is also the source of what is called substantive due process. During the first third of the twentieth century, the Supreme Court often nullified state and federal laws using substantive due process. In 1905, for example, in *Lochner v. New York*, the Supreme Court voided a New York statute that limited the number of hours that bakers could work in a single week. New York had passed the law to protect the health of employees, but the court found that this law interfered with the basic constitutional right of private parties to freely contract with one another. Over the next thirty years, dozens of state and federal laws were struck down that aimed to improve working conditions, secure social welfare, or establish the rights of unions. However, in 1934, during the Great Depression, the court reversed itself and began upholding the kinds of laws it had struck down earlier.

Since then, the court has employed a two-tiered analysis of substantive due process claims. Under the first tier, legislation on economic matters, employment relations, and other business affairs is subject to minimal judicial scrutiny. This means that a law will be overturned only if it serves no rational government purpose. Under the second tier, legislation concerning fundamental liberties is subject to “heightened judicial scrutiny,” meaning that a law will be invalidated unless it is “narrowly tailored to serve a significant government purpose.”

The Supreme Court has identified two distinct categories of fundamental liberties. The first category includes most of the liberties expressly enumerated in the Bill of Rights. Through a process known as selective incorporation, the court has interpreted the due process clause of the Fourteenth Amendment to bar states from denying their residents the most important freedoms guaranteed in the first ten amendments to the federal Constitution. Only the Third Amendment right (against involuntary quartering of soldiers) and the Fifth Amendment right to be indicted by a grand jury have not been made applicable to the states. Because these rights are still not applicable to state governments, the Supreme Court is often said to have “selectively incorporated” the Bill of Rights into the due process clause of the Fourteenth Amendment.

The second category of fundamental liberties includes those liberties that are not expressly stated in the Bill of Rights but that can be seen as essential to the concepts of freedom and equality in a democratic society. These unstated liberties come from Supreme

Court precedents, common law, moral philosophy, and deeply rooted traditions of US legal history. The Supreme Court has stressed that he word *liberty* cannot be defined by a definitive list of rights; rather, it must be viewed as a rational continuum of freedom through which every aspect of human behavior is protected from arbitrary impositions and random restraints. In this regard, as the Supreme Court has observed, the due process clause protects abstract liberty interests, including the right to personal autonomy, bodily integrity, self-dignity, and self-determination.

These liberty interests often are grouped to form a general right to privacy, which was first recognized in *Griswold v. Connecticut* (Section 4.6.1), where the Supreme Court struck down a state statute forbidding married adults from using, possessing, or distributing contraceptives on the ground that the law violated the sanctity of the marital relationship. According to Justice Douglas's plurality opinion, this penumbra of privacy, though not expressly mentioned in the Bill of Rights, must be protected to establish a buffer zone or breathing space for those freedoms that are constitutionally enumerated. The Supreme Court's ruling in *Dobbs v. Jackson Women's Health Organization*, 597 U.S. 215 (2022), discussed in Section 4.1, that reversed its decades-old precedent in *Roe v. Wade* suggests the court will be looking to narrow, rather than expand, constitutional rights identified through the application of substantive due process. (Ryb, Bella M. "Case Comment: Department of State v. Munoz and the Unbundling of Substantive Due Process" New York University Law Review, 2025.)

Fourteenth Amendment: Due Process and Equal Protection Guarantees

The Fourteenth Amendment (1868) requires that states treat citizens of other states with due process. This can be either an issue of procedural due process (as in Section 3.9, *Burger King v. Rudzewicz*) or an issue of substantive due process. For substantive due process, consider what happened in an Alabama court in *BMW of North America, Inc. v. Gore*, 517 U.S. 559 (1996)

The plaintiff, Dr. Ira Gore, bought a new BMW for $40,000 from a dealer in Alabama. He later discovered that the vehicle's exterior had been slightly damaged in transit from Europe and had therefore been repainted by the North American distributor prior to his purchase. The vehicle was, by best estimates, worth about 10 percent less than he paid for it. The distributor, BMW of North America, had routinely sold slightly damaged cars as brand new if the damage could be fixed for less than 3 percent of the cost of the car. In the trial, Dr. Gore sought $4,000 in compensatory damages and also punitive damages. The Alabama trial jury considered that BMW was engaging in a fraudulent practice and wanted to punish the defendant for a number of frauds it estimated at somewhere around a thousand nationwide. The jury awarded not only the $4,000 in compensatory damages but also $4 million in punitive damages, which was later reduced to $2 million by the Alabama Supreme Court. On appeal to the US Supreme Court, the court found that punitive damages may not be "grossly excessive." If they are, then they violate substantive due process. Whatever damages a state awards must be limited to what is reasonably necessary to vindicate the state's legitimate interest in punishment and deterrence.

"Equal protection of the laws" is a phrase that originates in the Fourteenth Amendment, adopted in 1868. The amendment provides that no state shall "deny to any person within its jurisdiction the equal protection of the laws." This is the equal protection clause. It means that, generally speaking, governments must treat people equally. Unfair classifications among people or corporations will not be permitted. A well-known example of unfair classification would be race discrimination: requiring white children and black children to attend different public schools or requiring "separate but equal" public services, such as water fountains or restrooms. Yet despite the clear intent of the 1868 amendment, "separate but equal" was the law of the land until *Brown v. Board of Education* (1954). (*Plessy v. Ferguson*, 163 US 537 (1896).)

Governments make classifications every day, so not all classifications can be illegal under the equal protection clause. People with more income generally pay a greater percentage of their income in taxes. People with proper medical training are licensed to become doctors; people without that training cannot be licensed and commit a criminal offense if they do practice medicine. To know what classifications are permissible under the Fourteenth Amendment, we need to know what is being classified. The court has created three classifications, and the outcome of any equal protection case can usually be predicted by knowing how the court is likely to classify the case:

- Minimal scrutiny: economic and social relations. Government actions are usually upheld if there is a rational basis for them.
- Intermediate scrutiny: gender. Government classifications are sometimes upheld.
- Strict scrutiny: race, ethnicity, and fundamental rights. Classifications based on any of these are almost never upheld.

Under minimal scrutiny for economic and social regulation, laws that regulate economic or social issues are presumed valid and will be upheld if they are rationally related to legitimate goals of government. So, for example, if the city of New Orleans limits the number of street vendors to some rational number (more than one but fewer than the total number that could possibly fit on the sidewalks), the local ordinance would not be overturned as a violation of equal protection.

Under intermediate scrutiny, the city of New Orleans might limit the number of street vendors who are men. For example, suppose that the city council decreed that all street vendors must be women, thinking that would attract even more tourism. A classification like this, based on sex, will have to meet a sterner test than a classification resulting from economic or social regulation. A law like this would have to substantially relate to important government objectives. Increasingly, courts have nullified government sex classifications as societal concern with gender equality has grown. (See Shannon Faulkner's case against The Citadel, an all-male state school.) (*United States v. Virginia*, 518 US 515 (1996).)

Suppose, however, that the city of New Orleans decided that no one of Middle Eastern heritage could drive a taxicab or be a street vendor. That kind of classification would be examined with strict scrutiny to see if there was any compelling justification for it. As noted, classifications such as this one are almost never upheld. The law would be upheld only if it were necessary to promote a compelling state interest. Very few laws that have a racial or ethnic classification meet that test.

The strict scrutiny test will be applied to classifications involving racial and ethnic criteria as well as classifications that interfere with a fundamental right. In *Palmore v. Sidoti*, the state refused to award custody to the mother because her new spouse was racially different from the child. (*Palmore v. Sidoti*, 466 US 429 (1984).) This practice was declared unconstitutional because the state had made a racial classification; this was presumptively invalid, and the government could not show a compelling need to enforce such a classification through its law. An example of government action interfering with a fundamental right will also receive strict scrutiny. When New York State gave an employment preference to veterans who had been state residents at the time of entering the military, the court declared that veterans who were new to the state were less likely to get jobs and that therefore the statute interfered with the right to travel, which was deemed a fundamental right. (*Atty. Gen. of New York v. Soto-Lopez*, 476 US 898 (1986).)

Key Takeaway

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

Exercises

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

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4.6: Summary and Exercises

Summary

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

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

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

Exercises

1. For many years, the Supreme Court believed that “commercial speech” was entitled to less protection than other forms of speech. One defining element of commercial speech is that its dominant theme is to propose a commercial transaction. This kind of speech is protected by the First Amendment, but the government is permitted to regulate it more closely than other forms of speech. However, the government must make reasonable distinctions, must narrowly tailor the rules restricting commercial speech, and must show that government has a legitimate goal that the law furthers.Edward Salib owned a Winchell’s Donut House in Mesa, Arizona. To attract customers, he displayed large signs in store windows. The city ordered him to remove the signs because they violated the city’s sign code, which prohibited covering more than 30 percent of a store’s windows with signs. Salib sued, claiming that the sign code violated his First Amendment rights. What was the result, and why?
2. Jennifer is a freshman at her local public high school. Her sister, Jackie, attends a nearby private high school. Neither school allows them to join its respective wrestling team; only boys can wrestle at either school. Do either of them have a winning case based on the equal protection clause of the Fourteenth Amendment?
3. The employees of the US Treasury Department that work the border crossing between the United States and Mexico learned that they will be subject to routine drug testing. The customs bureau, which is a division of the treasury department, announces this policy along with its reasoning: since customs agents must routinely search for drugs coming into the United States, it makes sense that border guards must themselves be completely drug-free. Many border guards do not use drugs, have no intention of using drugs, and object to the invasion of their privacy. What is the constitutional basis for their objection?
4. Happy Time Chevrolet employs Jim Bydalek as a salesman. Bydalek takes part in a Gay Pride March in Los Angeles, is interviewed by a local news camera crew, and reports that he is gay and proud of it. His employer is not, and he is fired. Does he have any constitutional causes of action against his employer?
5. You begin work at the Happy-Go-Lucky Corporation on Halloween. On your second day at work, you wear a political button on your coat, supporting your choice for US senator in the upcoming election. Your boss, who is of a different political persuasion, looks at the button and says, “Take that stupid button off or you’re fired.” Has your boss violated your constitutional rights?
6. David Lucas paid $975,000 for two residential parcels on the Isle of Palms near Charleston, South Carolina. His intention was to build houses on them. Two years later, the South Carolina legislature passed a statute that prohibited building beachfront properties. The purpose was to leave the dunes system in place to mitigate the effects of hurricanes and strong storms. The South Carolina Coastal Commission created the rules and regulations with substantial input from the community and from experts and with protection of the dune system primarily in mind. People had been building on the shoreline for years, with harmful results to localities and the state treasury. When Lucas applied for permits to build two houses near the shoreline, his permits were rejected. He sued, arguing that the South Carolina legislation had effectively “taken” his property. At trial, South Carolina conceded that because of the legislation, Lucas’s property was effectively worth zero. Has there been a taking under

the Fifth Amendment (as incorporated through the Fourteenth Amendment), and if so, what should the state owe to Lucas? Suppose that Lucas could have made an additional $1 million by building a house on each of his parcels. Is he entitled to recover his original purchase price or his potential profits?

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CHAPTER OVERVIEW

5: Criminal Law

Learning Objectives

After reading this chapter, you should understand the following:

- Explain how criminal law differs from civil law.
- Categorize the various types of crimes and define the most serious felonies.
- Discuss and question the criminal "intent" of a corporation.
- Explain basic criminal procedure and the rights of criminal defendants.

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

5.1: Introduction to Criminal Law
5.2: Types of Crimes
5.3: The Nature of a Criminal Act
5.4: Responsibility
5.5: Procedure
5.6: Constitutional Rights of the Accused
5.7: Summary and Exercises

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5.1: Introduction to Criminal Law

Criminal law is the most ancient branch of the law. Many wise observers have tried to define and explain it, but the explanations often include many complex and subtle distinctions. A traditional criminal law course would include a lot of discussions on criminal intent, the nature of criminal versus civil responsibility, and the constitutional rights accorded the accused. But in this chapter, we will consider only the most basic aspects of intent, responsibility, and constitutional rights.

Unlike civil actions, where plaintiffs seek compensation or other remedies for themselves, crimes involve "the state" (the federal government, a state government, or some subunit of state government). This is because crimes involve some "harm to society" and not just harm to certain individuals. But "harm to society" is not always evident in the act itself. For example, two friends of yours at a party argue, take the argument outside, and blows are struck; one has a bloody nose and immediately goes home. The crimes of assault and battery have been committed, even though no one else knows about the fight and the friends later make up. By contrast, suppose a major corporation publicly announces that it is closing operations in your community and moving operations to Southeast Asia. There is plenty of harm to a local community as the plant closes down and no new jobs take the place of the company's jobs. Although the effects on society are greater in the second example, only the first example is a crime.

Crimes are generally defined by legislatures, in statutes; the statutes describe in general terms the nature of the conduct they wish to criminalize. For government punishment to be fair, citizens must have clear notice of what is criminally prohibited. Ex post facto laws—laws created "after the fact" to punish an act that was legal at the time—are expressly prohibited by the US Constitution. Overly vague statutes can also be struck down by courts under a constitutional doctrine known as "void for vagueness."

What is considered a crime will also vary from society to society and from time to time. For example, while cocaine use was legal in the United States at one time, it is now a controlled substance, and unauthorized use is now a crime. Medical marijuana was not legal fifty years ago when its use began to become widespread, and in some states its use or possession was a felony. Now, some states make it legal to use or possess it under some circumstances. In the United States, you can criticize and make jokes about the president of the United States without committing a crime, but in many countries it is a serious criminal act to criticize a public official.

Attitudes about what constitutes a crime and appropriate punishment for crimes will also vary considerably from nation to nation. Uganda has decreed long prison sentences, and even death, for homosexuals. In Saudi Arabia, the government has proposed to deliberately paralyze a criminal defendant who criminally assaulted someone and unintentionally caused the victim's paralysis. Limits on punishment are set in the United States through the Constitution's prohibition on "cruel or unusual punishments."

It is often said that ignorance of the law is no excuse. But there are far too many criminal laws for anyone to know them all. Also, because most people do not actually read statutes, the question of "criminal intent" comes up right away: if you don't know that the legislature has made driving without a seat belt fastened a misdemeanor, you cannot have intended to harm society. You might even argue that there is no harm to anyone but yourself!

The usual answer to this is that the phrase "ignorance of the law is no excuse" means that society (through its elected representatives) gets to decide what is harmful to society, not you. Still, you may ask, "Isn't it my choice whether to take the risk of failing to wear a seat belt? Isn't this a victimless crime? Where is the harm to society?" A policymaker or social scientist may answer that your injuries, statistically, are generally going to be far greater if you don't wear one and that your choice may actually impose costs on society. For example, you might not have enough insurance, so that a public hospital will have to take care of your head injuries, injuries that would likely have been avoided by your use of a seat belt.

But, as just noted, it is hard to know the meaning of some criminal laws. Teenagers hanging around the sidewalks on Main Street were sometimes arrested for "loitering." The constitutional void-for-vagueness doctrine has led the courts to overturn statutes that are not clear. For example, "vagrancy" was long held to be a crime, but US courts began some sixty years ago to overturn vagrancy and "suspicious person" statutes on the grounds that they are too vague for people to know what they are being asked not to do.

This requirement that criminal statutes not be vague does not mean that the law always defines crimes in ways that can be easily and clearly understood. Many statutes use terminology developed by the common-law courts. For example, a California statute defines murder as "the unlawful killing of a human being, with malice aforethought." (Cal. Pen. Code, § 187.) If no history backed up these words, they would be unconstitutionally vague. But there is a rich history of judicial decisions that provides meaning for much of the arcane language like "malice aforethought" strewn about in the statute books.

Because a crime is an act that the legislature has defined as socially harmful, the parties involved cannot agree among themselves to forget a particular incident, such as a barroom brawl, if the authorities decide to prosecute. This is one of the critical distinctions between criminal and civil law. An assault is both a crime and a tort. The person who was assaulted may choose to forgive his assailant and not to sue him for damages. But he cannot stop the prosecutor from bringing an indictment against the assailant.

A crime consists of an act defined as criminal—an actus reus—and the requisite "criminal intent." Someone who has a burning desire to kill a rival in business or romance and who may actually intend to murder but does not act on his desire has not committed a crime. He may have a "guilty mind"—the translation of the Latin phrase mens rea—but he is guilty of no crime. A person who is forced to commit a crime at gunpoint is not guilty of a crime, because although there was an act defined as criminal—an actus reus—there was no criminal intent.

Key Takeaway

Crimes are usually defined by statute and constitute an offense against society. In each case, there must be both an act and some mens rea (criminal intent).

Exercises

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

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5.2: Types of Crimes

Learning Objectives

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

- Categorize various types of crimes.
- Name and define the major felonies in criminal law.
- Explain how white-collar crime differs from other crimes.
- Define a variety of white-collar crimes.

Most classifications of crime turn on the seriousness of the act. In general, seriousness is defined by the nature or duration of the punishment set out in the statute. A felony is a crime punishable (usually) by imprisonment of more than one year or by death (crimes punishable by death are sometimes known as capital crimes; the use of capital punishment has decreased in recent decades in the United States.) The major felonies include murder, rape, kidnapping, armed robbery, embezzlement, insider trading, fraud, and racketeering. All other crimes are usually known as misdemeanors, petty offenses, or infractions. Misdemeanors are generally crimes in which punishment can include up to one year in jail. An infraction is a crime that cannot be punished by imprisonment. Another way of viewing crimes is by the type of social harm the statute is intended to prevent or deter, such as offenses against the person, offenses against property, and white-collar crime.

Offenses against the Person

Homicide

Homicide is the killing of one person by another. Not every killing is criminal. When the law permits one person to kill another—for example, a soldier killing an enemy on the battlefield during war, or a killing in self-defense—the death is considered the result of justifiable homicide. An *excusable homicide*, by contrast, is one in which death results from an accident in which the killer is not at fault.

All other homicides are criminal. The most severely punished form is murder, defined as homicide committed with “malice aforethought.” This is a term with a very long history. Boiled down to its essentials, it means that the defendant had the intent to kill. A killing need not be premeditated for any long period of time; the premeditation might be quite sudden, as in a bar fight that escalates in that moment when one of the fighters reaches for a knife with the intent to kill.

Sometimes a homicide can be murder even if there is no intent to kill; an intent to inflict great bodily harm can be murder if the result is the death of another person. A killing that takes place while a felony (such as armed robbery) is being committed is also murder, whether or not the killer intended any harm. This is the so-called felony murder rule. Examples are the accidental discharge of a gun that kills an innocent bystander or the asphyxiation death of a fireman from smoke resulting from a fire set by an arsonist. The felony murder rule is more significant than it sounds, because it also applies to the accomplices of one who does the killing. Thus the driver of a getaway car stationed a block away from the scene of the robbery can be convicted of murder if a gun accidentally fires during the robbery and someone is killed. Manslaughter is an act of killing that does not amount to murder. Voluntary manslaughter is an intentional killing, but one carried out in the “sudden heat of passion” as the result of some provocation. An example is a fight that gets out of hand. Involuntary manslaughter entails a lesser degree of willfulness; it usually occurs when someone has taken a reckless action that results in death (e.g., a death resulting from a traffic accident in which one driver recklessly runs a red light).

Assault and Battery

Ordinarily, we would say that a person who has struck another has “assaulted” him. Technically, that is a battery—the unlawful application of force to another person. The force need not be violent. Indeed, a man who kisses a woman is guilty of a battery if he does it against her will. The other person may consent to the force. That is one reason why surgeons require patients to sign consent forms, giving the doctor permission to operate. In the absence of such a consent, an operation is a battery. That is also why football players are not constantly being charged with battery. Those who agree to play football agree to submit to the rules of the game,

which of course include the right to tackle. But the consent does not apply to all acts of physical force: a hockey player who hits an opponent over the head with his stick can be prosecuted for the crime of battery.

Criminal assault is an *attempt* to commit a battery or the deliberate placing of another in fear of receiving an immediate battery. If you throw a rock at a friend, but he manages to dodge it, you have committed an assault. Some states limit an assault to an attempt to commit a battery by one who has a "present ability" to do so. Pointing an unloaded gun and threatening to shoot would not be an assault, nor, of course, could it be a battery. The modem tendency, however, is to define an assault as an attempt to commit a battery by one with an *apparent* ability to do so.

Assault and battery may be excused. For example, a bar owner (or her agent, the bouncer) may use reasonable force to remove an unruly patron. If the use of force is excessive, the bouncer can be found guilty of assault and battery, and a civil action could arise against the bar owner as well.

Offenses against Property

Theft: Larceny, Robbery, Embezzlement, False Pretenses

The concept of theft is familiar enough. Less familiar is the way the law has treated various aspects of the act of stealing. Criminal law distinguishes among many different crimes that are popularly known as theft. Many technical words have entered the language —burglary, larceny, robbery—but are often used inaccurately. Brief definitions of the more common terms are discussed here.

The basic crime of stealing personal property is larceny. By its old common-law definition, still in use today, larceny is the wrongful "taking and carrying away of the personal property of another with intent to steal the same."

The separate elements of this offense have given rise to all kinds of difficult cases. Take the theft of fruit, for example, with regard to the essential element of "personal property." If a man walking through an orchard plucks a peach from a tree and eats it, he is not guilty of larceny because he has not taken away *personal* property (the peach is part of the land, being connected to the tree). But if he picks up a peach lying on the ground, he is guilty of larceny. Or consider the element of "taking" or "carrying away." Sneaking into a movie theater without paying is not an act of larceny (though in most states it is a criminal act). Taking electricity by tapping into the power lines of an electric utility was something that baffled judges late in the nineteenth century because it was not clear whether electricity is a "something" that can be taken. Modern statutes have tended to make clear that electricity can be the object of larceny. Or consider the element of an "intent to steal the same." If you borrow your friend's BMW without his permission in order to go to the grocery store, intending to return it within a few minutes and then do return it, you have not committed larceny. But if you meet another friend at the store who convinces you to take a long joyride with the car and you return hours later, you may have committed larceny.

A particular form of larceny is robbery, which is defined as larceny from a person by means of violence or intimidation.

Larceny involves the taking of property from the possession of another. Suppose that a person legitimately comes to possess the property of another and wrongfully appropriates it—for example, an automobile mechanic entrusted with your car refuses to return it, or a bank teller who is entitled to temporary possession of cash in his drawer takes it home with him. The common law had trouble with such cases because the thief in these cases already had possession; his crime was in assuming ownership. Today, such wrongful conversion, known as embezzlement, has been made a statutory offense in all states.

Statutes against larceny and embezzlement did not cover all the gaps in the law. A conceptual problem arises in the case of one who is tricked into giving up his title to property. In larceny and embezzlement, the thief gains possession or ownership without any consent of the owner or custodian of the property. Suppose, however, that an automobile dealer agrees to take his customer's present car as a trade-in. The customer says that he has full title to the car. In fact, the customer is still paying off an installment loan and the finance company has an interest in the old car. If the finance company repossesses the car, the customer—who got a new car at a discount because of his false representation—cannot be said to have taken the new car by larceny or embezzlement. Nevertheless, he tricked the dealer into selling, and the dealer will have lost the value of the repossessed car. Obviously, the customer is guilty of a criminal act; the statutes outlawing it refer to this trickery as the crime of false pretenses, defined as obtaining ownership of the property of another by making untrue representations of fact with intent to defraud.

A number of problems have arisen in the judicial interpretation of false-pretense statutes. One concerns whether the taking is permanent or only temporary. The case of *State v. Mills* (Section 6.7) shows the subtle questions that can be presented and the

dangers inherent in committing “a little fraud.”

In the *Mills* case, the claim was that a mortgage instrument dealing with one parcel of land was used instead for another. This is a false representation of fact. Suppose, by contrast, that a person misrepresents his state of mind: “I will pay you back tomorrow,” he says, knowing full well that he does not intend to. Can such a misrepresentation amount to false pretenses punishable as a criminal offense? In most jurisdictions it cannot. A false-pretense violation relates to a past event or existing fact, not to a statement of intention. If it were otherwise, anyone failing to pay a debt might find himself facing criminal prosecution, and business would be less prone to take risks.

The problem of proving intent is especially difficult when a person has availed himself of the services of another without paying. A common example is someone leaving a restaurant without paying for the meal. In most states, this is specifically defined in the statutes as *theft of services*.

Receiving Stolen Property

One who engages in receiving stolen property with knowledge that it is stolen is guilty of a felony or misdemeanor, depending on the value of the property. The receipt need not be personal; if the property is delivered to a place under the control of the receiver, then he is deemed to have received it. “Knowledge” is construed broadly: not merely actual knowledge, but (correct) belief and suspicion (strong enough not to investigate for fear that the property will turn out to have been stolen) are sufficient for conviction.

Forgery

Forgery is false writing of a document of legal significance (or apparent legal significance!) with intent to defraud. It includes the making up of a false document or the alteration of an existing one. The writing need not be done by hand but can be by any means —typing, printing, and so forth. Documents commonly the subject of forgery are negotiable instruments (checks, money orders, and the like), deeds, receipts, contracts, and bills of lading. The forged instrument must itself be false, not merely contain a falsehood. If you fake your neighbor’s signature on one of his checks made out to cash, you have committed forgery. But if you sign a check of your own that is made out to cash, knowing that there is no money in your checking account, the instrument is not forged, though the act may be criminal if done with the intent to defraud.

The mere making of a forged instrument is unlawful. So is the “uttering” (or presentation) of such an instrument, whether or not the one uttering it actually forged it. The usual example of a false signature is by no means the only way to commit forgery. If done with intent to defraud, the backdating of a document, the modification of a corporate name, or the filling in of lines left blank on a form can all constitute forgery.

Extortion

Under common law, extortion could only be committed by a government official, who corruptly collected an unlawful fee under color of office. A common example is a salaried building inspector who refuses to issue a permit unless the permittee pays him. Under modern statutes, the crime of extortion has been broadened to include the wrongful collection of money or something else of value by anyone by means of a threat (short of a threat of immediate physical violence, for such a threat would make the demand an act of robbery). This kind of extortion is usually called blackmail. The blackmail threat commonly is to expose some fact of the victim’s private life or to make a false accusation about him.

Offenses against Habitation and Other Offenses

Burglary

Burglary is not a crime against property. In California, it defined as entering a structure, vehicle, or locked container with the intent to commit a felony or theft (grand or petty larceny) inside, even if no force is used and the intended crime isn't completed. (Cal. Pen. Code, § 459.) The intent to steal is not an issue: a man who sneaks into a woman’s home intent on stealing her property her has committed a burglary, even if he does not carry out the act. The student doing critical thinking will no doubt notice that the definition provides plenty of room for argument. What is “breaking”? (The courts do not require actual destruction; the mere opening of a closed door, even if unlocked, is enough.) What is entry? What kind of intent? Can a landlord burglarize the dwelling of his tenant? (Yes.) Can a person burglarize her own home? (No.)

Arson

Under common law, arson was the malicious burning of the dwelling of another. Burning one's own house for purposes of collecting insurance was not an act of arson under common law. The statutes today make it a felony intentionally to set fire to any building, whether or not it is a dwelling and whether or not the purpose is to collect insurance.

Bribery

Bribery is a corrupt payment (or receipt of such a payment) for official action. The payment can be in cash or in the form of any goods, intangibles, or services that the recipient would find valuable. Under common law, only a public official could be bribed. In most states, bribery charges can result from the bribe of anyone performing a public function.

Bribing a public official in government procurement (contracting) can result in serious criminal charges. Bribing a public official in a foreign country to win a contract can result in charges under the Foreign Corrupt Practices Act.

Perjury

Perjury is the crime of giving a false oath, either orally or in writing, in a judicial or other official proceeding (lies made in proceedings other than courts are sometimes termed "false swearing"). To be perjurious, the oath must have been made corruptly—that is, with knowledge that it was false or without sincere belief that it was true. An innocent mistake is not perjury. A statement, though true, is perjury if the maker of it believes it to be false. Statements such as "I don't remember" or "to the best of my knowledge" are not sufficient to protect a person who is lying from conviction for perjury. To support a charge of perjury, however, the false statement must be "material," meaning that the statement is relevant to whatever the court is trying to find out.

White-Collar Crime

White-collar crime, as distinguished from "street crime," refers generally to fraud-related acts carried out in a nonviolent way, usually connected with business. Armed bank robbery is not a white-collar crime, but embezzlement by a teller or bank officer is. Many white-collar crimes are included within the statutory definitions of embezzlement and false pretenses. Most are violations of state law. Depending on how they are carried out, many of these same crimes are also violations of federal law.

Any act of fraud in which the United States postal system is used or which involves interstate phone calls or Internet connections is a violation of federal law. Likewise, many different acts around the buying and selling of securities can run afoul of federal securities laws. Other white-collar crimes include tax fraud; price fixing; violations of food, drug, and environmental laws; corporate bribery of foreign companies; and—the newest form—computer fraud. Some of these are discussed here; others are covered in later chapters.

Mail and Wire Fraud

Federal law prohibits the use of the mails or any interstate electronic communications medium for the purpose of furthering a "scheme or artifice to defraud." The statute is broad, and it is relatively easy for prosecutors to prove a violation. The law also bans attempts to defraud, so the prosecutor need not show that the scheme worked or that anyone suffered any losses. "Fraud" is broadly construed: anyone who uses the mails or telephone to defraud anyone else of virtually anything, not just of money, can be convicted under the law. In one case, a state governor was convicted of mail fraud when he took bribes to influence the setting of racing dates. The court's theory was that he defrauded the citizenry of its right to his "honest and faithful services" as governor. (*United States v. Isaacs*, 493 F.2d 1124 (7th Cir. 1974).)

Violations of Antitrust Law

In Chapter 26 we consider the fundamentals of antitrust law, which for the most part affects the business enterprise civilly. But violations of Section 1 of the Sherman Act, which condemns activities in "restraint of trade" (including price fixing), are also crimes.

Violations of the Food and Drug Act

The federal Food, Drug, and Cosmetic Act prohibits any person or corporation from sending into interstate commerce any adulterated or misbranded food, drug, cosmetics, or related device. For example, in a 2010 case, Allergen had to pay a criminal fine for marketing Botox as a headache or pain reliever, a use that had not been approved by the Food and Drug Administration. Unlike

most criminal statutes, willfulness or deliberate misconduct is not an element of the act. As the *United States v. Park* case (Section 6.7) shows, an executive can be held criminally liable even though he may have had no personal knowledge of the violation.

Environmental Crimes

Many federal environmental statutes have criminal provisions. These include the Federal Water Pollution Control Act (commonly called the Clean Water Act); the Rivers and Harbors Act of 1899 (the Refuse Act); the Clean Air Act; the Federal Insecticide, Fungicide, and Rodenticide Act (FIFRA); the Toxic Substances Control Act (TSCA); and the Resource Conservation and Recovery Act (RCRA). Under the Clean Water Act, for example, wrongful discharge of pollutants into navigable waters carries a fine ranging from $2,500 to $25,000 per day and imprisonment for up to one year. “Responsible corporate officers” are specifically included as potential defendants in criminal prosecutions under the act. They can include officers who have responsibility over a project where subcontractors and their employees actually caused the discharge. (*U.S. v. Hanousek*, 176 F.3d 1116 (9th Cir. 1999).)

Violations of the Foreign Corrupt Practices Act

As a byproduct of Watergate, federal officials at the Securities and Exchange Commission and the Internal Revenue Service uncovered many instances of bribes paid by major corporations to officials of foreign governments to win contracts with those governments. Congress responded in 1977 with the Foreign Corrupt Practices Act, which imposed a stringent requirement that the disposition of assets be accurately and fairly accounted for in a company’s books and records. The act also made illegal the payment of bribes to foreign officials or to anyone who will transmit the money to a foreign official to assist the payor (the one offering and delivering the money) in getting business.

Violations of the Racketeering Influenced and Corrupt Organizations Act

In 1970 Congress enacted the Racketeering Influenced and Corrupt Organizations Act (RICO), aimed at ending organized crime’s infiltration into legitimate business. The act tells courts to construe its language broadly “to effectuate its remedial purpose,” and many who are not part of organized crime have been successfully prosecuted under the act. It bans a “pattern of racketeering,” defined as the commission of at least two acts within ten years of any of a variety of already-existing crimes, including mail, wire, and securities fraud. The act thus makes many types of fraud subject to severe penalties.

Computer Crime

Computer crime generally falls into four categories: (1) theft of money, financial instruments, or property; (2) misappropriation of computer time; (3) theft of programs; and (4) illegal acquisition of information. The main federal statutory framework for many computer crimes is the Computer Fraud and Abuse Act (CFAA; see Table 6.1). Congress only prohibited computer fraud and abuse where there was a federal interest, as where computers of the government were involved or where the crime was interstate in nature.

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

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

Key Takeaway

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

Exercises

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

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5.3: The Nature of a Criminal Act

Learning Objectives

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

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

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

Attempt

It is not necessary to commit the intended crime to be found guilty of a criminal offense. An *attempt* to commit the crime is punishable as well, though usually not as severely. For example, Brett points a gun at Ashley, intending to shoot her dead. He pulls the trigger but his aim is off, and he misses her heart by four feet. He is guilty of an attempt to murder. Suppose, however, that earlier in the day, when he was preparing to shoot Ashley, Brett had been overheard in his apartment muttering to himself of his intention, and that a neighbor called the police. When they arrived, he was just snapping his gun into his shoulder holster.

At that point, courts in most states would not consider him guilty of an attempt because he had not passed beyond the stage of *preparation*. After having buttoned his jacket he might have reconsidered and put the gun away. Determining when the accused has passed beyond mere preparation and taken an actual step toward *perpetrating* the crime is often difficult and is usually for the jury to decide.

Impossibility

What if a defendant is accused of attempting a crime that is factually impossible? For example, suppose that a husband intended to poison his wife with strychnine in her coffee, but put sugar in the coffee instead? The "mens rea" or criminal intent was there, but the act itself was not criminal (murder by poisoning requires the use of poison). States are divided on this, but thirty-seven states have ruled out factual impossibility as a defense to the crime of attempt.

Legal impossibility is different, and is usually acknowledged as a valid defense. If the defendant completes all of his intended acts, but those acts do not fulfill all the required elements of a crime, there could be a successful "impossibility" defense. If Rafael (who has poor sight), shoots at a tree stump, thinking it is his neighbor, Minh, intending to kill him, has he committed an attempt? Many courts would hold that he has not. But the distinction between factual impossibility and legal impossibility is not always clear, and the trend seems to be to punish the intended attempt.

Conspiracy

Under both federal and state laws, it is a separate offense to work with others toward the commission of a crime. When two or more people combine to carry out an unlawful purpose, they are engaged in a conspiracy. The law of conspiracy is quite broad, especially when it is used by prosecutors in connection with white-collar crimes. Many people can be swept up in the net of conspiracy, because it is unnecessary to show that the actions they took were sufficient to constitute either the crime or an attempt. Usually, the prosecution needs to show only (1) an agreement and (2) a single overt act in furtherance of the conspiracy. Thus if three people agree to rob a bank, and if one of them goes to a store to purchase a gun to be used in the holdup, the three can be convicted of conspiracy to commit robbery. Even the purchase of an automobile to be used as the getaway car could support a conspiracy conviction.

The act of any one of the conspirators is imputed to the other members of the conspiracy. It does not matter, for instance, that only one of the bank robbers fired the gun that killed a guard. All can be convicted of murder. That is so even if one of the conspirators was stationed as a lookout several blocks away and even if he specifically told the others that his agreement to cooperate would end "just as soon as there is shooting."

Agency and Corporations

A person can be guilty of a crime if he acts through another. Again, the usual reason for "imputing" the guilt of the actor to another is that both were engaged in a conspiracy. But imputation of guilt is not limited to a conspiracy. The agent may be innocent even though he participates. A corporate officer directs a junior employee to take a certain bag and deliver it to the officer's home. The employee reasonably believes that the officer is entitled to the bag. Unbeknownst to the employee, the bag contains money that belongs to the company, and the officer wishes to keep it. This is not a conspiracy. The employee is not guilty of larceny, but the officer is, because the agent's act is imputed to him.

Since intent is a necessary component of crime, an agent's intent cannot be imputed to his principal if the principal did not share the intent. The company president tells her sales manager, "Go make sure our biggest customer renews his contract for next year"—by which she meant, "Don't ignore our biggest customer." Standing before the customer's purchasing agent, the sales manager threatens to tell the purchasing agent's boss that the purchasing agent has been cheating on his expense account, unless he signs a new contract. The sales manager could be convicted of blackmail, but the company president could not.

Can a corporation be guilty of a crime? For many types of crimes, the guilt of individual employees may be imputed to the corporation. Thus the antitrust statutes explicitly state that the corporation may be convicted and fined for violations by employees. This is so even though the shareholders are the ones who ultimately must pay the price—and who may have had nothing to do with the crime nor the power to stop it. The law of corporate criminal responsibility has been changing in recent years. The tendency is to hold the corporation liable under criminal law if the act has been directed by a responsible officer or group within the corporation (the president or board of directors).

Key Takeaway

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

Exercises

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

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5.4: Responsibility

Learning Objectives

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

- Explain why criminal law generally requires that the defendant charged with a crime have criminal "intent."
- Know and explain the possible excuses relating to responsibility that are legally recognized by courts, including lack of capacity.

In General

The mens rea requirement depends on the nature of the crime and all the circumstances surrounding the act. In general, though, the requirement means that the accused must in some way have intended the criminal consequences of his act. Suppose, for example, that Charlie gives Gabrielle a poison capsule to swallow. That is the act. If Gabrielle dies, is Charlie guilty of murder? The answer depends on what his state of mind was. Obviously, if he gave it to her intending to kill her, the act was murder.

What if he gave it to her knowing that the capsule was poison but believing that it would only make her mildly ill? The act is still murder, because we are all liable for the consequences of any intentional act that may cause harm to others. But suppose that Gabrielle had asked Harry for aspirin, and he handed her two pills that he reasonably believed to be aspirin (they came from the aspirin bottle and looked like aspirin) but that turned out to be poison, the act would not be murder, because he had neither intent nor a state of knowledge from which intent could be inferred.

Not every criminal law requires criminal intent as an ingredient of the crime. Many regulatory codes dealing with the public health and safety impose strict requirements. Failure to adhere to such requirements is a violation, whether or not the violator had mens rea. The *United States v. Park* case, Section 6.7, a decision of the US Supreme Court, shows the different considerations involved in mens rea.

Excuses That Limit or Overcome Responsibility

Mistake of Fact and Mistake of Law

Ordinarily, ignorance of the *law* is not an excuse. If you believe that it is permissible to turn right on a red light but the city ordinance prohibits it, your belief, even if reasonable, does not excuse your violation of the law. Under certain circumstances, however, ignorance of law will be excused. If a statute imposes criminal penalties for an action taken without a license, and if the government official responsible for issuing the license formally tells you that you do not need one (though in fact you do), a conviction for violating the statute cannot stand. In rare cases, a lawyer's advice, contrary to the statute, will be held to excuse the client, but usually the client is responsible for his attorney's mistakes. Otherwise, as it is said, the lawyer would be superior to the law.

Ignorance or mistake of *fact* more frequently will serve as an excuse. If you take a coat from a restaurant, believing it to be yours, you cannot be convicted of larceny if it is not. Your honest mistake of fact negates the requisite intent. In general, the rule is that a mistaken belief of fact will excuse criminal responsibility if (1) the belief is honestly held, (2) it is reasonable to hold it, and (3) the act would not have been criminal if the facts were as the accused supposed them to have been.

Entrapment

One common technique of criminal investigation is the use of an undercover agent or decoy—the policeman who poses as a buyer of drugs from a street dealer or the elaborate "sting" operations in which ostensibly stolen goods are "sold" to underworld "fences." Sometimes these methods are the only way by which certain kinds of crime can be rooted out and convictions secured.

But a rule against entrapment limits the legal ability of the police to play the role of criminals. The police are permitted to use such techniques to detect criminal activity; they are not permitted to do so to instigate crime. The distinction is usually made between a person who intends to commit a crime and one who does not. If the police provide the former with an opportunity to commit a criminal act—the sale of drugs to an undercover agent, for example—there is no defense of entrapment. But if the police knock on

the door of one not known to be a drug user and persist in a demand that he purchase drugs from them, finally overcoming his will to resist, a conviction for purchase and possession of drugs can be overturned on the ground of entrapment.

Other Excuses

A number of other circumstances can limit or excuse criminal liability. These include compulsion (a gun pointed at one's head by a masked man who apparently is unafraid to use the weapon and who demands that you help him rob a store), honest consent of the "victim" (the quarterback who is tackled), adherence to the requirements of legitimate public authority lawfully exercised (a policeman directs a towing company to remove a car parked in a tow-away zone), the proper exercise of domestic authority (a parent may spank a child, within limits), and defense of self, others, property, and habitation. Each of these excuses is a complex subject in itself.

Lack of Capacity

A further defense to criminal prosecution is the lack of mental capacity to commit the crime. Infants and children are considered incapable of committing a crime; under common law any child under the age of seven could not be prosecuted for any act. That age of incapacity varies from state to state and is now usually defined by statutes. Likewise, insanity or mental disease or defect can be a complete defense. Intoxication can be a defense to certain crimes, but the mere fact of drunkenness is not ordinarily sufficient.

Key Takeaway

In the United States, some crimes can be committed by not following strict regulatory requirements for health, safety, or the environment. The law does provide excuses from criminal liability for mistakes of fact, entrapment, and lack of capacity.

Exercises

1. Describe several situations in which compulsion, consent, or other excuses remove criminal liability.
2. Your employee is drunk on the job and commits the crime of assault and battery on a customer. He claims lack of capacity as an excuse. Should the courts accept this excuse? Why or why not?

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5.5: Procedure

Learning Objectives

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

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

The procedure for criminal prosecutions is complex. Procedures will vary from state to state. A criminal case begins with an arrest if the defendant is caught in the act or fleeing from the scene; if the defendant is not caught, a warrant for the defendant's arrest will issue. The warrant is issued by a judge or a magistrate upon receiving a complaint detailing the charge of a specific crime against the accused. It is not enough for a police officer to go before a judge and say, "I'd like you to arrest Bonnie because I think she's just murdered Clyde." She must supply enough information to satisfy the magistrate that there is probable cause (reasonable grounds) to believe that the accused committed the crime. The warrant will be issued to any officer or agency that has power to arrest the accused with warrant in hand.

The accused will be brought before the magistrate for a preliminary hearing. The purpose of the hearing is to determine whether there is sufficient reason to hold the accused for trial. If so, the accused can be sent to jail or be permitted to make bail. Bail is a sum of money paid to the court to secure the defendant's attendance at trial. If he fails to appear, he forfeits the money. Constitutionally, bail can be withheld only if there is reason to believe that the accused will flee the jurisdiction.

Once the arrest is made, the case is in the hands of the prosecutor. In the fifty states, prosecution is a function of the district attorney's office. These offices are usually organized on a county-by-county basis. In the federal system, criminal prosecution is handled by the office of the US Attorney, one of whom is appointed for every federal district.

Following the preliminary hearing, the prosecutor must either file a complaint (a document stating the crime of which the person being held is accused) or ask the grand jury for an indictment. The grand jury consists of a group of citizens appointed by the court to determine whether there is sufficient evidence to warrant a prosecution. It does not sit to determine guilt or innocence. The indictment is the grand jury's formal declaration of charges on which the accused will be tried. If indicted, the accused formally becomes a defendant.

The defendant will then be arraigned, that is, brought before a judge to answer the accusation in the complaint or indictment. The defendant may plead guilty or not guilty. If he pleads not guilty, the case will be tried before a jury (sometimes referred to as a petit jury). The jury cannot convict unless it finds the defendant guilty beyond a reasonable doubt.

The defendant might have pleaded guilty to the offense or to a lesser charge (often referred to as a "lesser included offense"—simple larceny, for example, is a lesser included offense of robbery because the defendant may not have used violence but nevertheless stole from the victim). Such a plea is usually arranged through "plea bargaining" with the prosecution. In return for the plea to a charge, the prosecutor promises to recommend to the judge that the sentence be limited. The judge most often, but not always, goes along with the prosecutor's recommendation.

The defendant is also permitted to file a plea of nolo contendere (no contest) in prosecutions for certain crimes. In so doing, he neither affirms nor denies his guilt. He may be sentenced as though he had pleaded guilty, although usually a nolo plea is the result of a plea bargain. Why plead nolo? In some offenses, such as violations of the antitrust laws, the statutes provide that private plaintiffs may use a conviction or a guilty plea as proof that the defendant violated the law. This enables a plaintiff to prove liability without putting on witnesses or evidence and reduces the civil trial to a hearing about the damages to plaintiff. The nolo plea permits the defendant to avoid this, so that any plaintiff will have to not only prove damages but also establish civil liability.

Following a guilty plea or a verdict of guilt, the judge will impose a sentence after presentencing reports are written by various court officials (often, probation officers). Permissible sentences are spelled out in statutes, though these frequently give the judge a range within which to work (e.g., twenty years to life). The judge may sentence the defendant to imprisonment, a fine, or both, or may decide to suspend sentence (i.e., the defendant will not have to serve the sentence as long as he stays out of trouble).

Sentencing usually comes before appeal. As in civil cases, the defendant, now convicted, has the right to take at least one appeal to higher courts, where issues of procedure and constitutional rights may be argued.

Key Takeaway

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

Exercises

1. Harold is charged with the crime of assault with a deadly weapon with intent to kill or inflict serious bodily injury. It is a more serious crime than simple assault. Harold's attorney wants the prosecutor to give Harold a break, but Harold is guilty of at least simple assault and may also have had the intent to kill. What is Harold's attorney likely to do?
2. Kumar was driving his car, smoking marijuana, and had an accident with another vehicle. The other driver was slightly injured. When the officer arrived, she detected a strong odor of marijuana in Kumar's car and a small amount of marijuana in the glove compartment. The other driver expects to bring a civil action against Kumar for her injuries after Kumar's criminal case. What should Kumar plead in the criminal case—careless driving or driving under the influence?

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5.6: Constitutional Rights of the Accused

Learning Objectives

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

- Describe the most significant constitutional rights of defendants in US courts, and name the source of these rights.
- Explain the Exclusionary rule and the reason for its existence.

Search and Seizure

The rights of those accused of a crime are spelled out in four of the ten constitutional amendments that make up the Bill of Rights (Amendments Four, Five, Six, and Eight). For the most part, these amendments have been held to apply to both the federal and the state governments. The Fourth Amendment says in part that "the right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated." Although there are numerous and tricky exceptions to the general rule, ordinarily the police may not break into a person's house or confiscate his papers or arrest him unless they have a warrant to do so. This means, for instance, that a police officer cannot simply stop you on a street corner and ask to see what is in your pockets (a power the police enjoy in many other countries), nor can your home be raided without probable cause to believe that you have committed a crime. What if the police do search or seize unreasonably?

The courts have devised a remedy for the use at trial of the fruits of an unlawful search or seizure. Evidence that is unconstitutionally seized is excluded from the trial. This is the so-called exclusionary rule, first made applicable in federal cases in 1914 and brought home to the states in 1961. The exclusionary rule is highly controversial, and there are numerous exceptions to it. But it remains generally true that the prosecutor may not use evidence willfully taken by the police in violation of constitutional rights generally, and most often in the violation of Fourth Amendment rights. (The fruits of a coerced confession are also excluded.)

Double Jeopardy

The Fifth Amendment prohibits the government from prosecuting a person twice for the same offense. The amendment says that no person shall be "subject for the same offence to be twice put in jeopardy of life or limb." If a defendant is acquitted, the government may not appeal. If a defendant is convicted and his conviction is upheld on appeal, he may not thereafter be reprosecuted for the same crime.

Self-Incrimination

The Fifth Amendment is also the source of a person's right against self-incrimination (no person "shall be compelled in any criminal case to be a witness against himself"). The debate over the limits of this right has given rise to an immense literature. In broadest outline, the right against self-incrimination means that the prosecutor may not call a defendant to the witness stand during trial and may not comment to the jury on the defendant's failure to take the stand. Moreover, a defendant's confession must be excluded from evidence if it was not voluntarily made (e.g., if the police beat the person into giving a confession). In *Miranda v. Arizona*, the Supreme Court ruled that no confession is admissible if the police have not first advised a suspect of his constitutional rights, including the right to have a lawyer present to advise him during the questioning. (*Miranda v. Arizona*, 384 US 436 (1966).) These so-called Miranda warnings have prompted scores of follow-up cases that have made this branch of jurisprudence especially complex.

Speedy Trial

The Sixth Amendment tells the government that it must try defendants speedily. How long a delay is too long depends on the circumstances in each case. In 1975, Congress enacted the Speedy Trial Act to give priority to criminal cases in federal courts. It requires all criminal prosecutions to go to trial within seventy-five days (though the law lists many permissible reasons for delay).

Cross-Examination

The Sixth Amendment also says that the defendant shall have the right to confront witnesses against him. No testimony is permitted to be shown to the jury unless the person making it is present and subject to cross-examination by the defendant's counsel.

Assistance of Counsel

The Sixth Amendment guarantees criminal defendants the right to have the assistance of defense counsel. During the eighteenth century and before, the British courts frequently refused to permit defendants to have lawyers in the courtroom during trial. The right to counsel is much broader in this country, as the result of Supreme Court decisions that require the state to pay for a lawyer for indigent defendants in most criminal cases.

Cruel and Unusual Punishment

Punishment under the common law was frequently horrifying. Death was a common punishment for relatively minor crimes. In many places throughout the world, punishments still persist that seem cruel and unusual, such as the practice of stoning someone to death. The guillotine, famously in use during and after the French Revolution, is no longer used, nor are defendants put in stocks for public display and humiliation. In pre-Revolutionary America, an unlucky defendant who found himself convicted could face brutal torture before death.

The Eighth Amendment banned these actions with the words that "cruel and unusual punishments [shall not be] inflicted." Virtually all such punishments either never were enacted or have been eliminated from the statute books in the United States. Nevertheless, the Eighth Amendment has become a source of controversy, first with the Supreme Court's ruling in 1976 that the death penalty, as haphazardly applied in the various states, amounted to cruel and unusual punishment. Later Supreme Court opinions have made it easier for states to administer the death penalty. As of 2026, there were approximately 2,100 defendants on death row in the United States (of which, around 550 are in California prisons). Of course, no corporation is on death row, and no corporation's charter has ever been revoked by a US state, even though some corporations have repeatedly been indicted and convicted of criminal offenses.

Presumption of Innocence

The most important constitutional right in the US criminal justice system is the presumption of innocence. The Supreme Court has repeatedly cautioned lower courts in the United States that juries must be properly instructed that the defendant is innocent until proven guilty. This is the origin of the "beyond all reasonable doubt" standard of proof and is an instruction given to juries in each criminal case. The Fifth Amendment notes the right of "due process" in federal proceedings, and the Fourteenth Amendment requires that each state provide "due process" to defendants.

Key Takeaway

The US Constitution provides several important protections for criminal defendants, including a prohibition on the use of evidence that has been obtained by unconstitutional means. This would include evidence seized in violation of the Fourth Amendment and confessions obtained in violation of the Fifth Amendment.

Exercises

1. Do you think it is useful to have a presumption of innocence in criminal cases? What if there were not a presumption of innocence in criminal cases?
2. Do you think public humiliation, public execution, and unusual punishments would reduce the amount of crime? Why do you think so?
3. "Due process" is another phrase for "fairness." Why should the public show fairness toward criminal defendants?

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5.7: Summary and Exercises

Summary

Criminal law is that branch of law governing offenses against society. Most criminal law requires a specific intent to commit the prohibited act (although a very few economic acts, made criminal by modern legislation, dispense with the requirement of intent). In this way, criminal law differs from much of civil law—for example, from the tort of negligence, in which carelessness, rather than intent, can result in liability.

Major crimes are known as felonies. Minor crimes are known as misdemeanors. Most people have a general notion about familiar crimes, such as murder and theft. But conventional knowledge does not suffice for understanding technical distinctions among related crimes, such as larceny, robbery, and false pretenses. These distinctions can be important because an individual can be found guilty not merely for committing one of the acts defined in the criminal law but also for attempting or conspiring to commit such an act. It is usually easier to convict someone of attempt or conspiracy than to convict for the main crime, and a person involved in a conspiracy to commit a felony may find that very little is required to put him into serious trouble.

Of major concern to the business executive is white-collar crime, which encompasses a host of offenses, including bribery, embezzlement, fraud, restraints of trade, and computer crime. Anyone accused of crime should know that they always have the right to consult with a lawyer and should always do so.

Exercises

1. Bill is the chief executive of a small computer manufacturing company that desperately needs funds to continue operating. One day a stranger comes to Bill to induce him to take part in a cocaine smuggling deal that would net Bill millions of dollars. Unbeknownst to Bill, the stranger is an undercover policeman. Bill tells the stranger to go away. The stranger persists, and after five months of arguing and cajoling, the stranger wears down Bill's will to resist. Bill agrees to take delivery of the cocaine and hands over a down payment of $10,000 to the undercover agent, who promptly arrests him for conspiracy to violate the narcotics laws. What defenses does Bill have?
2. You are the manager of a bookstore. A customer becomes irritated at having to stand in line and begins to shout at the salesclerk for refusing to wait on him. You come out of your office and ask the customer to calm down. He shouts at you. You tell him to leave. He refuses. So you and the salesclerk pick him up and shove him bodily out the door. He calls the police to have you arrested for assault. Should the police arrest you? Assuming that they do, how would you defend yourself in court?
3. Marilyn is arrested for arson against a nuclear utility, a crime under both state and federal law. She is convicted in state court and sentenced to five years in jail. Then the federal government decides to prosecute her for the same offense. Does she have a double-jeopardy defense against the federal prosecution?
4. Tectonics, a US corporation, is bidding on a project in Nigeria, and its employee wins the bid by secretly giving $100,000 to the Nigerian public official that has the most say about which company will be awarded the contract. The contract is worth $80 million, and Tectonics expects to make at least $50 million on the project. Has a crime under US law been committed?
5. Suppose that the CEO of Tectonics, Ted Nelson, is not actually involved in bribery of the Nigerian public official Adetutu Adeleke. Instead, suppose that the CFO, Jamie Skillset, is very accomplished at insulating both top management and the board of directors from some of the "operational realities" within the company. Skillset knows that Whoopi Goldmine, a Nigerian employee of Tectonics, has made the deal with Adeleke and secured the contract for Tectonics. Is it possible that Nelson, as well as Skillset, can be found guilty of a crime?
6. You have graduated from college and, after working hard for ten years, have scraped enough money together to make a down payment on a forty-acre farm within driving distance to the small city where you work in Colorado. In town at lunch one day, you run into an old friend from high school, Hayley Mills, who tells you that she is saving her money to start a high-end consignment shop in town. You allow her to have a room in your house for a few months until she has enough money to go into business. Over the following weeks, however, you realize that old acquaintances from high school are stopping by almost daily for short visits. When you bring this up to Hayley, she admits that many old friends are now relying on her for marijuana. She is not a licensed caregiver in Colorado and is clearly violating the law. Out of loyalty, you tell her that she has three weeks to move out, but you do not prevent her from continuing sales while she is there. What crime have you committed?

7. The Center Art Galleries—Hawaii sells artwork, and much of it involves art by the famous surrealist painter Salvador Dali. The federal government suspected the center of selling forged Dali artwork and obtained search warrants for six locations controlled by the center. The warrants told the executing officer to seize any items that were "evidence of violations of federal criminal law." The warrants did not describe the specific crime suspected, nor did the warrants limit the seizure of items solely to Dali artwork or suspected Dali forgeries. Are these search warrants valid?*Center Art Galleries—Hawaii, Inc. v. United States*, 875 F.2d 747 (9th Cir. 1989).

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CHAPTER OVERVIEW

6: Tort Law

Learning Objectives

After reading this chapter, you should understand the following:

- Know why most legal systems have tort law.
- Identify the three kinds of torts.
- Show how tort law relates to criminal law and contract law.
- Understand negligent torts and defenses to claims of negligence.
- Understand strict liability torts and the reasons for them in the US legal system.

In civil litigation, contract and tort claims are by far the most numerous. The law attempts to adjust for harms done by awarding damages to a successful plaintiff who demonstrates that the defendant was the cause of the plaintiff's losses. Torts can be intentional torts, negligent torts, or strict liability torts. Employers must be aware that in many circumstances their employees may create liability in tort. This chapter explains the different kind of torts, as well as available defenses to tort claims.

6.1: Purpose of Tort Laws

6.2: Intentional Torts

6.3: Negligence

6.4: Strict Liability

6.5: Summary and Exercises

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6.1: Purpose of Tort Laws

Learning Objectives

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

- Explain why a sound market system requires tort law.
- Define a tort and give two examples.
- Explain the moral basis of tort liability.
- Understand the purposes of damage awards in tort.

Definition of *Tort*

The term *tort* is the French equivalent of the English word *wrong*. The word *tort* is also derived from the Latin word *tortum*, which means twisted or crooked or wrong, in contrast to the word *rectum*, which means straight (*rectitude* uses that Latin root). Thus conduct that is twisted or crooked and not straight is a tort. The term was introduced into the English law by the Norman jurists.

Long ago, *tort* was used in everyday speech; today it is left to the legal system. A judge will instruct a jury that a tort is usually defined as a wrong for which the law will provide a remedy, most often in the form of money damages. The law does not remedy all "wrongs." The preceding definition of tort does not reveal the underlying principles that divide wrongs in the legal sphere from those in the moral sphere. Hurting someone's feelings may be more devastating than saying something untrue about him behind his back; yet the law will not provide a remedy for saying something cruel to someone directly, while it may provide a remedy for "defaming" someone, orally or in writing, to others.

Although the word is no longer in general use, tort suits are the stuff of everyday headlines. More and more people injured by exposure to a variety of risks now seek redress (some sort of remedy through the courts). Headlines boast of multimillion-dollar jury awards against doctors who bungled operations, against newspapers that libeled subjects of stories, and against oil companies that devastate entire ecosystems. All are examples of tort suits.

The law of torts developed almost entirely in the common-law courts; that is, statutes passed by legislatures were not the source of law that plaintiffs usually relied on. Usually, plaintiffs would rely on the common law (judicial decisions). Through thousands of cases, the courts have fashioned a series of rules that govern the conduct of individuals in their noncontractual dealings with each other. Through contracts, individuals can craft their own rights and responsibilities toward each other. In the absence of contracts, tort law holds individuals legally accountable for the consequences of their actions. Those who suffer losses at the hands of others can be compensated.

Many acts (like homicide) are both criminal and tortious. But torts and crimes are different, and the difference is worth noting. A crime is an act against the people as a whole. Society punishes the murderer; it does not usually compensate the family of the victim. Tort law, on the other hand, views the death as a private wrong for which damages are owed. In a civil case, the tort victim or his family, not the state, brings the action. The judgment against a defendant in a civil tort suit is usually expressed in monetary terms, not in terms of prison times or fines, and is the legal system's way of trying to make up for the victim's loss.

Kinds of Torts

There are three kinds of torts: intentional torts, negligent torts, and strict liability torts. Intentional torts arise from intentional acts, whereas unintentional torts often result from carelessness (e.g., when a surgical team fails to remove a clamp from a patient's abdomen when the operation is finished). Both intentional torts and negligent torts imply some fault on the part of the defendant. In strict liability torts, by contrast, there may be no fault at all, but tort law will sometimes require a defendant to make up for the victim's losses even where the defendant was not careless and did not intend to do harm.

Dimensions of Tort Liability

There is a clear moral basis for recovery through the legal system where the defendant has been careless (negligent) or has intentionally caused harm. Using the concepts that we are free and autonomous beings with basic rights, we can see that when others interfere with either our freedom or our autonomy, we will usually react negatively. As the old saying goes, "Your right to

swing your arm ends at the tip of my nose." The law takes this even one step further: under intentional tort law, if you frighten someone by swinging your arms toward the tip of her nose, you may have committed the tort of assault, even if there is no actual touching (battery).

Under a capitalist market system, rational economic rules also call for no negative externalities. That is, actions of individuals, either alone or in concert with others, should not negatively impact third parties. The law will try to compensate third parties who are harmed by your actions, even as it knows that a money judgment cannot actually mend a badly injured victim.

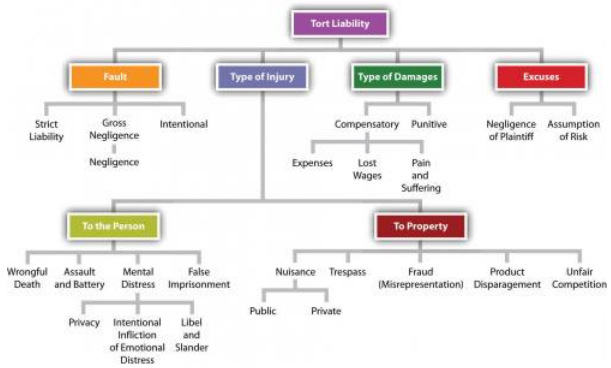


Figure 7.1 Dimensions of Tort Liability

Dimensions of Tort: Fault

Tort principles can be viewed along different dimensions. One is the **fault** dimension. Like criminal law, tort law requires a wrongful act by a defendant for the plaintiff to recover. Unlike criminal law, however, there need not be a specific intent. Since tort law focuses on injury to the plaintiff, it is less concerned than criminal law about the reasons for the defendant's actions. An innocent act or a relatively innocent one may still provide the basis for liability. Nevertheless, tort law—except for strict liability—relies on standards of fault, or blameworthiness.

The most obvious standard is willful conduct. If the defendant (often called the tortfeasor—i.e., the one committing the tort) intentionally injures another, there is little argument about tort liability. Thus all crimes resulting in injury to a person or property (murder, assault, arson, etc.) are also torts, and the plaintiff may bring a separate lawsuit to recover damages for injuries to his person, family, or property.

Most tort suits do not rely on *intentional* fault. They are based, rather, on *negligent* conduct that in the circumstances is careless or poses unreasonable risks of causing damage. A person can be liable for negligence where she has a legal duty to others (like driving safely), breached that duty, and the breach of that duty caused another to suffer actual harm. Most automobile accident and medical malpractice suits are examples of negligence suits.

The fault dimension is a continuum. At one end is the deliberate desire to do injury. The middle ground is occupied by careless conduct. At the other end is conduct that most would consider entirely blameless, in the moral sense. The defendant may have observed all possible precautions and yet still be held liable. This is called strict liability. An example is that incurred by the manufacturer of a defective product that is placed on the market despite all possible precautions, including quality-control inspection. In many states, if the product causes injury, the manufacturer will be held liable.

Dimensions of Tort: Nature of Injury

Tort liability varies by the type of injury caused. The most obvious type is physical harm to the person (assault, battery, infliction of emotional distress, negligent exposure to toxic pollutants, wrongful death) or property (trespass, nuisance, arson, interference with contract). Mental suffering can be redressed if it is a result of physical injury (e.g., shock and depression following an automobile accident). A few states now permit recovery for mental distress alone (a mother's shock at seeing her son injured by a car while both were crossing the street). Other protected interests include a person's reputation (injured by defamatory statements or writings), privacy (injured by those who divulge secrets of his personal life), and economic interests (misrepresentation to secure an economic advantage, certain forms of unfair competition).

Dimensions of Tort: Excuses

A third element in the law of torts is the excuse for committing an apparent wrong. The law does not condemn every act that ultimately results in injury.

One common rule of exculpation is **assumption of risk**. A baseball fan who sits along the third base line close to the infield assumes the risk that a line drive foul ball may fly toward him and strike him. He will not be permitted to complain in court that the batter should have been more careful or that management should have either warned him or put up a protective barrier.

Another excuse is negligence of the plaintiff. If two drivers are careless and hit each other on the highway, some states will refuse to permit either to recover from the other. Still another excuse is consent: two boxers in the ring consent to being struck with fists (but not to being bitten on the ear).

Damages

Since the purpose of tort law is to compensate the victim for harm actually done, damages are usually measured by the extent of the injury. Expressed in money terms, these include replacement of property destroyed, compensation for lost wages, reimbursement for medical expenses, and dollars that are supposed to approximate the pain that is suffered. Damages for these injuries are called **compensatory damages**.

In certain instances, the courts will permit an award of **punitive damages**. As the word *punitive* implies, the purpose is to punish the defendant's actions. Because a punitive award (sometimes called exemplary damages) is at odds with the general purpose of tort law, it is allowable only in aggravated situations. The law in most states permits recovery of punitive damages only when the defendant has deliberately committed a wrong with malicious intent or has otherwise done something outrageous.

Punitive damages are rarely allowed in negligence cases for that reason. But if someone sets out intentionally and maliciously to hurt another person, punitive damages may well be appropriate. Punitive damages are intended not only to punish the wrongdoer, by exacting an additional and sometimes heavy payment (the exact amount is left to the discretion of jury and judge), but also to deter others from similar conduct. The punitive damage award has been subject to heavy criticism in recent years in cases in which it has been awarded against manufacturers. One fear is that huge damage awards on behalf of a multitude of victims could swiftly bankrupt the defendant. Unlike compensatory damages, punitive damages are taxable.

Key Takeaway

There are three kinds of torts, and in two of them (negligent torts and strict liability torts), damages are usually limited to making the victim whole through an enforceable judgment for money damages. These compensatory damages awarded by a court accomplish only approximate justice for the injuries or property damage caused by a tortfeasor. Tort laws go a step further toward deterrence, beyond compensation to the plaintiff, in occasionally awarding punitive damages against a defendant. These are almost always in cases where an intentional tort has been committed.

Exercises

1. Why is deterrence needed for intentional torts (where punitive damages are awarded) rather than negligent torts?
2. Why are costs imposed on others without their consent problematic for a market economy? What if the law did not try to reimpose the victim's costs onto the tortfeasor? What would a totally non-litigious society be like?

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6.2: Intentional Torts

Learning Objectives

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

- Distinguish intentional torts from other kinds of torts.
- Give three examples of an intentional tort—one that causes injury to a person, one that causes injury to property, and one that causes injury to a reputation.

The analysis of most intentional torts is straightforward and parallels the substantive crimes already discussed in Chapter 6. When physical injury or damage to property is caused, there is rarely debate over liability if the plaintiff deliberately undertook to produce the harm. Certain other intentional torts are worth noting for their relevance to business.

Assault and Battery

One of the most obvious intentional torts is assault and battery. Both criminal law and tort law serve to restrain individuals from using physical force on others. Assault is (1) the threat of immediate harm or offense of contact or (2) any act that would arouse reasonable apprehension of imminent harm. Battery is unauthorized and harmful or offensive physical contact with another person that causes injury.

Often an assault results in battery, but not always. In *Western Union Telegraph Co. v. Hill*, for example, the defendant did not touch the plaintiff's wife, but the case presented an issue of possible assault even without an actual battery; the defendant employee attempted to kiss a customer across the countertop, couldn't quite reach her, but nonetheless created actionable fear (or, as the court put it, "apprehension") on the part of the plaintiff's wife. It is also possible to have a battery without an assault. For example, if someone hits you on the back of the head with an iron skillet and you didn't see it coming, there is a battery but no assault. Likewise, if Andrea passes out from drinking too much at the fraternity party and a stranger (Andre) kisses her on the lips while she is passed out, she would not be aware of any threat of offensive contact and would have no apprehension of any harm. Thus there has been no tort of assault, but she could allege the tort of battery. (The question of what damages, if any, would be an interesting argument.)

Under the doctrine of transferred intent, if Draco aims his wand at Harry but Harry ducks just in time and the impact is felt by Hermione instead, English law (and American law) would transfer Draco's intent from the target to the actual victim of the act. Thus Hermione could sue Draco for battery for any damages she had suffered.

False Imprisonment

The tort of false imprisonment originally implied a locking up, as in a prison, but today it can occur if a person is restrained in a room or a car or even if his or her movements are restricted while walking down the street. People have a right to be free to go as they please, and anyone who without cause deprives another of personal freedom has committed a tort. Damages are allowed for time lost, discomfort and resulting ill health, mental suffering, humiliation, loss of reputation or business, and expenses such as attorneys' fees incurred as a result of the restraint (such as a false arrest). But as the case of *Lester v. Albers Super Markets, Inc.* (Section 7.5) shows, the defendant must be shown to have restrained the plaintiff in order for damages to be allowed.

Intentional Infliction of Emotional Distress

Until recently, the common-law rule was that there could be no recovery for acts, even though intentionally undertaken, that caused purely mental or emotional distress. For a case to go to the jury, the courts required that the mental distress result from some physical injury. In recent years, many courts have overthrown the older rule and now recognize the so-called new tort. In an employment context, however, it is rare to find a case where a plaintiff is able to recover. The most difficult hurdle is proving that the conduct was "extreme" or "outrageous."

In an early California case, bill collectors came to the debtor's home repeatedly and threatened the debtor's pregnant wife. Among other things, they claimed that the wife would have to deliver her child in prison. The wife miscarried and had emotional and physical complications. The court found that the behavior of the collection company's two agents was sufficiently outrageous to

prove the tort of intentional infliction of emotional distress. In *Roche v. Stern* (New York), the famous cable television talk show host Howard Stern had tastelessly discussed the remains of Deborah Roche, a topless dancer and cable access television host. (*Roche v. Stern*, 675 N.Y.S.2d 133 (1998).) The remains had been brought to Stern's show by a close friend of Roche, Chaunce Hayden, and a number of crude comments by Stern and Hayden about the remains were videotaped and broadcast on a national cable television station. Roche's sister and brother sued Howard Stern and Infinity broadcasting and were able to get past the defendant's motion to dismiss to have a jury consider their claim.

A plaintiff's burden in these cases is to show that the mental distress is severe. Many states require that this distress must result in physical symptoms such as nausea, headaches, ulcers, or, as in the case of the pregnant wife, a miscarriage. Other states have not required physical symptoms, finding that shame, embarrassment, fear, and anger constitute severe mental distress.

Trespass and Nuisance

Trespass is intentionally going on land that belongs to someone else or putting something on someone else's property and refusing to remove it. This part of tort law shows how strongly the law values the rights of property owners. The right to enjoy your property without interference from others is also found in common law of nuisance. There are limits to property owners' rights, however. In *Katko v. Briney*, for example, the plaintiff was injured by a spring gun while trespassing on the defendant's property. (*Katko v. Briney*, 183 N.W.2d 657 (Iowa 1971).) The defendant had set up No Trespassing signs after ten years of trespassing and housebreaking events, with the loss of some household items. Windows had been broken, and there was "messing up of the property in general." The defendants had boarded up the windows and doors in order to stop the intrusions and finally had set up a shotgun trap in the north bedroom of the house. One defendant had cleaned and oiled his 20-gauge shotgun and taken it to the old house where it was secured to an iron bed with the barrel pointed at the bedroom door. "It was rigged with wire from the doorknob to the gun's trigger so would fire when the door was opened." The angle of the shotgun was adjusted to hit an intruder in the legs. The spring could not be seen from the outside, and no warning of its presence was posted.

The plaintiff, Katko, had been hunting in the area for several years and considered the property abandoned. He knew it had long been uninhabited. He and a friend had been to the house and found several old bottles and fruit jars that they took and added to their collection of antiques. When they made a second trip to the property, they entered by removing a board from a porch window. When the plaintiff opened the north bedroom door, the shotgun went off and struck him in the right leg above the ankle bone. Much of his leg was blown away. While Katko knew he had no right to break and enter the house with intent to steal bottles and fruit jars, the court held that a property owner could not protect an unoccupied boarded-up farmhouse by using a spring gun capable of inflicting death or serious injury.

In *Katko*, there is an intentional tort. But what if someone trespassing is injured by the negligence of the landowner? States have differing rules about trespass and negligence. In some states, a trespasser is only protected against the gross negligence of the landowner. In other states, trespassers may be owed the duty of due care on the part of the landowner. The burglar who falls into a drained swimming pool, for example, may have a case against the homeowner unless the courts or legislature of that state have made it clear that trespassers are owed the limited duty to avoid gross negligence. Or a very small child may wander off his own property and fall into a gravel pit on a nearby property and suffer death or serious injury; if the pit should (in the exercise of due care) have been filled in or some barrier erected around it, then there was negligence. But if the state law holds that the duty to trespassers is only to avoid gross negligence, the child's family would lose, unless the state law makes an exception for very young trespassers. In general, guests, licensees, and invitees are owed a duty of due care; a trespasser may not be owed such a duty, but states have different rules on this.

Intentional Interference with Contractual Relations

Tortious interference with a contract can be established by proving four elements:

1. There was a contract between the plaintiff and a third party.
2. The defendant knew of the contract.
3. The defendant improperly induced the third party to breach the contract or made performance of the contract impossible.
4. There was injury to the plaintiff.

In a famous case of contract interference, Texaco was sued by Pennzoil for interfering with an agreement that Pennzoil had with Getty Oil. After complicated negotiations between Pennzoil and Getty, a takeover share price was struck, a memorandum of

understanding was signed, and a press release announced the agreement in principle between Pennzoil and Getty. Texaco's lawyers, however, believed that Getty oil was "still in play," and before the lawyers for Pennzoil and Getty could complete the paperwork for their agreement, Texaco announced it was offering Getty shareholders an additional $12.50 per share over what Pennzoil had offered.

Texaco later increased its offer to $228 per share, and the Getty board of directors soon began dealing with Texaco instead of Pennzoil. Pennzoil decided to sue in Texas state court for tortious interference with a contract. After a long trial, the jury returned an enormous verdict against Texaco: $7.53 billion in actual damages and $3 billion in punitive damages. The verdict was so large that it would have bankrupted Texaco. Appeals from the verdict centered on an obscure rule of the Securities and Exchange Commission (SEC), Rule 10(b)-13, and Texaco's argument was based on that rule and the fact that the contract had not been completed. If there was no contract, Texaco could not have legally interfered with one. After the SEC filed a brief that supported Texaco's interpretation of the law, Texaco agreed to pay $3 billion to Pennzoil to dismiss its claim of tortious interference with a contract.

Malicious Prosecution

Malicious prosecution is the tort of causing someone to be prosecuted for a criminal act, knowing that there was no probable cause to believe that the plaintiff committed the crime. The plaintiff must show that the defendant acted with malice or with some purpose other than bringing the guilty to justice. A mere complaint to the authorities is insufficient to establish the tort, but any official proceeding will support the claim—for example, a warrant for the plaintiff's arrest. The criminal proceeding must terminate in the plaintiff's favor in order for his suit to be sustained.

A majority of US courts, though by no means all, permit a suit for wrongful civil proceedings. Civil litigation is usually costly and burdensome, and one who forces another to defend himself against baseless accusations should not be permitted to saddle the one he sues with the costs of defense. However, because, as a matter of public policy, litigation is favored as the means by which legal rights can be vindicated—indeed, the Supreme Court has even ruled that individuals have a constitutional right to litigate—the plaintiff must meet a heavy burden in proving his case. The mere dismissal of the original lawsuit against the plaintiff is not sufficient proof that the suit was unwarranted. The plaintiff in a suit for wrongful civil proceedings must show that the defendant (who was the plaintiff in the original suit) filed the action for an improper purpose and had no reasonable belief that his cause was legally or factually well grounded.

Defamation

Defamation is injury to a person's good name or reputation. In general, if the harm is done through the spoken word—one person to another, by telephone, by radio, or on television—it is called slander. If the defamatory statement is published in written form, it is called libel.

The Restatement (Second) of Torts defines a defamatory communication as one that "so tends to harm the reputation of another as to lower him in the estimation of the community or to deter third persons from associating or dealing with him."Restatement (Second) of Torts, Section 559 (1965).

A statement is not defamatory unless it is false. Truth is an absolute defense to a charge of libel or slander. Moreover, the statement must be "published"—that is, communicated to a third person. You cannot be libeled by one who sends you a letter full of false accusations and scurrilous statements about you unless a third person opens it first (your roommate, perhaps). Any living person is capable of being defamed, but the dead are not. Corporations, partnerships, and other forms of associations can also be defamed, if the statements tend to injure their ability to do business or to garner contributions.

The statement must have reference to a particular person, but he or she need not be identified by name. A statement that "the company president is a crook" is defamatory, as is a statement that "the major network weathermen are imposters." The company president and the network weathermen could show that the words were aimed at them. But statements about large groups will not support an action for defamation (e.g., "all doctors are butchers" is not defamatory of any particular doctor).

The law of defamation is largely built on strict liability. That a person did not intend to defame is ordinarily no excuse; a typographical error that converts a true statement into a false one in a newspaper, magazine, or corporate brochure can be sufficient to make out a case of libel. Even the exercise of due care is usually no excuse if the statement is in fact communicated. Repeating a

libel is itself a libel; a libel cannot be justified by showing that you were quoting someone else. Though a plaintiff may be able to prove that a statement was defamatory, he is not necessarily entitled to an award of damages. That is because the law contains a number of privileges that excuse the defamation.

Publishing false information about another business's product constitutes the tort of slander of quality, or trade libel. In some states, this is known as the tort of product disparagement. It may be difficult to establish damages, however. A plaintiff must prove that actual damages proximately resulted from the slander of quality and must show the extent of the economic harm as well.

Absolute Privilege

Statements made during the course of judicial proceedings are absolutely privileged, meaning that they cannot serve as the basis for a defamation suit. Accurate accounts of judicial or other proceedings are absolutely privileged; a newspaper, for example, may pass on the slanderous comments of a judge in court. "Judicial" is broadly construed to include most proceedings of administrative bodies of the government. The Constitution exempts members of Congress from suits for libel or slander for any statements made in connection with legislative business. The courts have constructed a similar privilege for many executive branch officials.

Qualified Privilege

Absolute privileges pertain to those in the public sector. A narrower privilege exists for private citizens. In general, a statement that would otherwise be actionable is held to be justified if made in a reasonable manner and for a reasonable purpose. Thus you may warn a friend to beware of dealing with a third person, and if you had reason to believe that what you said was true, you are privileged to issue the warning, even though false. Likewise, an employee may warn an employer about the conduct or character of a fellow or prospective employee, and a parent may complain to a school board about the competence or conduct of a child's teacher. There is a line to be drawn, however, and a defendant with nothing but an idle interest in the matter (an "officious intermeddler") must take the risk that his information is wrong.

In 1964, the Supreme Court handed down its historic decision in *New York Times v. Sullivan*, holding that under the First Amendment a libel judgment brought by a public official against a newspaper cannot stand unless the plaintiff has shown "actual malice," which in turn was defined as "knowledge that [the statement] was false or with a reckless disregard of whether it was false or not." (*Times v. Sullivan*, 376 US 254 (1964).) In subsequent cases, the court extended the constitutional doctrine further, applying it not merely to government officials but to public figures, people who voluntarily place themselves in the public eye or who involuntarily find themselves the objects of public scrutiny. Whether a private person is or is not a public figure is a difficult question that has so far eluded rigorous definition and has been answered only from case to case. A CEO of a private corporation ordinarily will be considered a private figure unless he puts himself in the public eye—for example, by starring in the company's television commercials.

Invasion of Privacy

The right of privacy—the right "to be let alone"—did not receive judicial recognition until the twentieth century, and its legal formulation is still evolving. In fact there is no single right of privacy. Courts and commentators have discerned at least four different types of interests: (1) the right to control the appropriation of your name and picture for commercial purposes, (2) the right to be free of intrusion on your "personal space" or seclusion, (3) freedom from public disclosure of embarrassing and intimate facts of your personal life, and (4) the right not to be presented in a "false light."

Appropriation of Name or Likeness

The earliest privacy interest recognized by the courts was appropriation of name or likeness: someone else placing your photograph on a billboard or cereal box as a model or using your name as endorsing a product or in the product name. A New York statute makes it a misdemeanor to use the name, portrait, or picture of any person for advertising purposes or for the purposes of trade (business) without first obtaining written consent. The law also permits the aggrieved person to sue and to recover damages for unauthorized profits and also to have the court enjoin (judicially block) any further unauthorized use of the plaintiff's name, likeness, or image. This is particularly useful to celebrities.

Because the publishing and advertising industries are concentrated heavily in New York, the statute plays an important part in advertising decisions made throughout the country. Deciding what "commercial" or "trade" purposes are is not always easy. Thus a

newsmagazine may use a baseball player's picture on its cover without first obtaining written permission, but a chocolate manufacturer could not put the player's picture on a candy wrapper without consent.

Personal Space

One form of intrusion upon a person's solitude—trespass—has long been actionable under common law. Physical invasion of home or other property is not a new tort. But in recent years, the notion of intrusion has been broadened considerably. Now, taking photos of someone else with your cell phone in a locker room could constitute invasion of the right to privacy. Reading someone else's mail or e-mail could also constitute an invasion of the right to privacy. Photographing someone on a city street is not tortious, but subsequent use of the photograph could be. Whether the invasion is in a public or private space, the amount of damages will depend on how the image or information is disclosed to others.

Public Disclosure of Embarassing Facts

Circulation of false statements that do injury to a person are actionable under the laws of defamation. What about true statements that might be every bit as damaging—for example, disclosure of someone's income tax return, revealing how much he earned? The general rule is that if the facts are truly private and of no "legitimate" concern to the public, then their disclosure is a violation of the right to privacy. But a person who is in the public eye cannot claim the same protection.

False Light

A final type of privacy invasion is that which paints a false picture in a publication. Though false, it might not be libelous, since the publication need contain nothing injurious to reputation. Indeed, the publication might even glorify the plaintiff, making him seem more heroic than he actually is. Subject to the First Amendment requirement that the plaintiff must show intent or extreme recklessness, statements that put a person in a false light, like a fictionalized biography, are actionable.

Key Takeaway

There are many kinds of intentional torts. Some of them involve harm to the physical person or to his or her property, reputation or feelings, or economic interests. In each case of intentional tort, the plaintiff must show that the defendant intended harm, but the intent to harm does not need to be directed at a particular person and need not be malicious, as long as the resulting harm is a direct consequence of the defendant's actions.

Exercises

1. Name two kinds of intentional torts that could result in damage to a business firm's bottom line.
2. Name two kinds of intentional torts that are based on protection of a person's property.
3. Why are intentional torts more likely to result in a verdict not only for compensatory damages but also for punitive damages?

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6.3: Negligence

Learning Objectives

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

- Understand how the duty of due care relates to negligence.
- Distinguish between actual and proximate cause.
- Explain the primary defenses to a claim of negligence.

Elements of Negligence

Physical harm need not be intentionally caused. A pedestrian knocked over by an automobile does not hurt less because the driver intended no wrong but was merely careless. The law imposes a duty of care on all of us in our everyday lives. Accidents caused by negligence are actionable.

Determining negligence is not always easy. If a driver runs a red light, we can say that he is negligent because a driver must always be careful to ascertain whether the light is red and be able to stop if it is. Suppose that the driver was carrying a badly injured person to a nearby hospital and that after slowing down at an intersection, went through a red light, blowing his horn, whereupon a driver to his right, seeing him, drove into the intersection anyway and crashed into him. Must one always stop at a red light? Is proof that the light was red always proof of negligence? Usually, but not always: negligence is an abstract concept that must always be applied to concrete and often widely varying sets of circumstances. Whether someone was or was not negligent is almost always a question of fact for a jury to decide. Rarely is it a legal question that a judge can settle.

The tort of negligence has four elements: (1) a duty of due care that the defendant had, (2) the breach of the duty of due care, (3) connection between cause and injury, and (4) actual damage or loss. Even if a plaintiff can prove each of these aspects, the defendant may be able to show that the law excuses the conduct that is the basis for the tort claim. We examine each of these factors below.

Standard of Care

Not every unintentional act that causes injury is negligent. If you brake to a stop when you see a child dart out in front of your car, and if the noise from your tires gives someone in a nearby house a heart attack, you have not acted negligently toward the person in the house. The purpose of the negligence standard is to protect others against the risk of injury that foreseeably would ensue from unreasonably dangerous conduct.

Given the infinite variety of human circumstances and conduct, no general statement of a reasonable standard of care is possible. Nevertheless, the law has tried to encapsulate it in the form of the famous standard of “the reasonable person.” This fictitious person “of ordinary prudence” is the model that juries are instructed to compare defendants with in assessing whether those defendants have acted negligently. Analysis of this mythical personage has baffled several generations of commentators. How much knowledge must he have of events in the community, of technology, of cause and effect? With what physical attributes, courage, or wisdom is this nonexistent person supposedly endowed? If the defendant is a person with specialized knowledge, like a doctor or an automobile designer, must the jury also treat the “reasonable person” as having this knowledge, even though the average person in the community will not? (Answer: in most cases, yes.)

Despite the many difficulties, the concept of the reasonable man is one on which most negligence cases ultimately turn. If a defendant has acted “unreasonably under the circumstances” and his conduct posed an unreasonable risk of injury, then he is liable for injury caused by his conduct. Perhaps in most instances, it is not difficult to divine what the reasonable man would do. The reasonable person stops for traffic lights and always drives at reasonable speeds, does not throw baseballs through windows, performs surgical operations according to the average standards of the medical profession, ensures that the floors of his grocery store are kept free of fluids that would cause a patron to slip and fall, takes proper precautions to avoid spillage of oil from his supertanker, and so on. The “reasonable person” standard imposes hindsight on the decisions and actions of people in society; the circumstances of life are such that courts may sometimes impose a standard of due care that many people might not find reasonable.

Duty of Care and Its Breach

The law does not impose on us a duty to care for every person. If the rule were otherwise, we would all, in this interdependent world, be our brothers' keepers, constantly unsure whether any action we took might subject us to liability for its effect on someone else. The law copes with this difficulty by limiting the number of people toward whom we owe a duty to be careful.

In general, the law imposes no obligation to act in a situation to which we are strangers. We may pass the drowning child without risking a lawsuit. But if we do act, then the law requires us to act carefully. The law of negligence requires us to behave with due regard for the foreseeable consequences of our actions in order to avoid unreasonable risks of injury.

During the course of the twentieth century, the courts have constantly expanded the notion of "foreseeability," so that today many more people are held to be within the zone of injury than was once the case. For example, it was once believed that a manufacturer or supplier owed a duty of care only to immediate purchasers, not to others who might use the product or to whom the product might be resold. This limitation was known as the rule of privity. And users who were not immediate purchasers were said not to be in privity with a supplier or manufacturer. In 1916, Judge Benjamin N. Cardozo, then on the New York Court of Appeals, penned an opinion in a celebrated case that exploded the theory of privity, though it would take half a century before the last state—Mississippi in 1966—would fall in line.

Determining a duty of care can be a vexing problem. Physicians, for example, are bound by principles of medical ethics to respect the confidences of their patients. Suppose a patient tells a psychiatrist that he intends to kill his girlfriend. Does the physician then have a higher legal duty to warn prospective victim? The California Supreme Court has said yes.(*Tarasoff v. Regents of University of California*, 13 Cal.3d 425 (1976).)

Establishing a breach of the duty of due care where the defendant has violated a statute or municipal ordinance is eased considerably with the doctrine of negligence per se, a doctrine common to all US state courts. If a legislative body sets a minimum standard of care for particular kinds of acts to protect a certain set of people from harm and a violation of that standard causes harm to someone in that set, the defendant is negligent per se. If Harvey is driving sixty-five miles per hour in a fifty-five-mile-per-hour zone when he crashes into Haley's car and the police accident report establishes that or he otherwise admits to going ten miles per hour over the speed limit, Haley does not have to prove that Harvey has breached a duty of due care. She will only have to prove that the speeding was an actual and proximate cause of the collision and will also have to prove the extent of the resulting damages to her.

Causation: Actual Cause and Proximate Cause

Can a butterfly flapping its wings in the South Atlantic in March be said to be the cause of a hurricane in the Caribbean in September? Virtually any cause of an injury can be traced to some preceding cause. The problem for the law is to know when to draw the line between causes that are immediate and causes too remote for liability reasonably to be assigned to them. In tort theory, there are two kinds of causes that a plaintiff must prove: actual cause and proximate cause. Actual cause (causation in fact) can be found if the connection between the defendant's act and the plaintiff's injuries passes the "but for" test: if an injury would not have occurred "but for" the defendant's conduct, then the defendant is the cause of the injury. Still, this is not enough causation to create liability. The injuries to the plaintiff must also be foreseeable, or not "too remote," for the defendant's act to create liability. This is proximate cause: a cause that is not too remote or unforeseeable. The law requires a close connection between the event and the injury to create liability. For instance, say a defective stove starts a fire in a shopping mall foot court kitchen, but a region-wide power outage and the shopping mall operator's failure to connect a backup battery prevents the kitchen's sprinkler system from activating to put out the fire. The entire mall burns down. The but for cause of the fire is the defective stove, but it is not the proximate cause of the mall burning down. It is unforeseeable that the entire mall would burn down due to a kitchen fire given the installation of a sprinkler system and backup power source.

Suppose that the person who was injured was not one whom a reasonable person could have expected to be harmed. Such a situation was presented in one of the most famous US tort cases, *Palsgraf v. Long Island Railroad* (Section 7.5), which was decided by Judge Benjamin Cardozo. Although Judge Cardozo persuaded four of his seven brethren to side with his position, the closeness of the case demonstrates the difficulty that unforeseeable consequences and unforeseeable plaintiffs present.

Damages

For a plaintiff to win a tort case, she must allege and prove that she was injured. The fear that she might be injured in the future is not a sufficient basis for a suit. This rule has proved troublesome in medical malpractice and industrial disease cases. A doctor's negligent act or a company's negligent exposure of a worker to some form of contamination might not become manifest in the body for years. In the meantime, the tort statute of limitations might have run out, barring the victim from suing at all. An increasing number of courts have eased the plaintiff's predicament by ruling that the statute of limitations does not begin to run until the victim discovers that she has been injured or contracted a disease.

The law allows an exception to the general rule that damages must be shown when the plaintiff stands in danger of immediate injury from a hazardous activity. If you discover your neighbor experimenting with explosives in his basement, you could bring suit to enjoin him from further experimentation, even though he has not yet blown up his house—and yours.

Problems of Proof

The plaintiff in a tort suit, as in any other, has the burden of proving his allegations.

He must show that the defendant took the actions complained of as negligent, demonstrate the circumstances that make the actions negligent, and prove the occurrence and extent of injury. Factual issues are for the jury to resolve. Since it is frequently difficult to make out the requisite proof, the law allows certain presumptions and rules of evidence that ease the plaintiff's task, on the ground that without them substantial injustice would be done. One important rule goes by the Latin phrase res ipsa loquitur, meaning "the thing speaks for itself." The best evidence is always the most direct evidence: an eyewitness account of the acts in question. But eyewitnesses are often unavailable, and in any event they frequently cannot testify directly to the reasonableness of someone's conduct, which inevitably can only be inferred from the circumstances.

In many cases, therefore, circumstantial evidence (evidence that is indirect) will be the only evidence or will constitute the bulk of the evidence. Circumstantial evidence can often be quite telling: though no one saw anyone leave the building, muddy footprints tracing a path along the sidewalk are fairly conclusive. Res ipsa loquitur is a rule of circumstantial evidence that permits the jury to draw an inference of negligence. A common statement of the rule is the following: "There must be reasonable evidence of negligence but where the thing is shown to be under the management of the defendant or his servants, and the accident is such as in the ordinary course of things does not happen if those who have the management use proper care, it affords reasonable evidence, in the absence of explanation by the defendants, that the accident arose from want of care." (*Scott v. London & St. Katherine Docks Co.*, 3 H. & C. 596, 159 Eng.Rep. 665 (Q.B. 1865).)

If a barrel of flour rolls out of a factory window and hits someone, or a soda bottle explodes, or an airplane crashes, courts in every state permit juries to conclude, in the absence of contrary explanations by the defendants, that there was negligence. The plaintiff is not put to the impossible task of explaining precisely how the accident occurred. A defendant can always offer evidence that he acted reasonably—for example, that the flour barrel was securely fastened and that a bolt of lightning, for which he was not responsible, broke its bands, causing it to roll out the window. But testimony by the factory employees that they secured the barrel, in the absence of any further explanation, will not usually serve to rebut the inference. That the defendant was negligent does not conclude the inquiry or automatically entitle the plaintiff to a judgment. Tort law provides the defendant with several excuses, some of which are discussed briefly in the next section.

Excuses

There are more excuses (defenses) than are listed here, but contributory negligence or comparative negligence, assumption of risk, and act of God are among the principal defenses that will completely or partially excuse the negligence of the defendant.

Contributory and Comparative Negligence

Under an old common-law rule, it was a complete defense to show that the plaintiff in a negligence suit was himself negligent. Even if the plaintiff was only mildly negligent, most of the fault being chargeable to the defendant, the court would dismiss the suit if the plaintiff's conduct contributed to his injury. In a few states today, this rule of contributory negligence is still in effect. Although referred to as negligence, the rule encompasses a narrower form than that with which the defendant is charged, because the plaintiff's only error in such cases is in being less careful of himself than he might have been, whereas the defendant is charged with conduct careless toward others. This rule was so manifestly unjust in many cases that most states, either by statute or judicial

decision, have changed to some version of comparative negligence. Under the rule of comparative negligence, damages are apportioned according to the defendant's degree of culpability. For example, if the plaintiff has sustained a $100,000 injury and is 20 percent responsible, the defendant will be liable for $80,000 in damages.

Assumption of Risk

Risk of injury pervades the modern world, and plaintiffs should not win a lawsuit simply because they took a risk and lost. The law provides, therefore, that when a person knowingly takes a risk, he or she must suffer the consequences.

The assumption of risk doctrine comes up in three ways. The plaintiff may have formally agreed with the defendant before entering a risky situation that he will relieve the defendant of liability should injury occur. ("You can borrow my car if you agree not to sue me if the brakes fail, because they're worn and I haven't had a chance to replace them.") Or the plaintiff may have entered into a relationship with the defendant knowing that the defendant is not in a position to protect him from known risks (the fan who is hit by a line drive in a ballpark). Or the plaintiff may act in the face of a risky situation known in advance to have been created by the defendant's negligence (failure to leave, while there was an opportunity to do so, such as getting into an automobile when the driver is known to be drunk).

The difficulty in many cases is to determine the dividing line between subjectivity and objectivity. If the plaintiff had no actual knowledge of the risk, he cannot be held to have assumed it. On the other hand, it is easy to claim that you did not appreciate the danger, and the courts will apply an objective standard of community knowledge (a "but you should have known" test) in many situations. When the plaintiff has no real alternative, however, assumption of risk fails as a defense (e.g., a landlord who negligently fails to light the exit to the street cannot claim that his tenants assumed the risk of using it).

At the turn of the century, courts applied assumption of risk in industrial cases to bar relief to workers injured on the job. They were said to assume the risk of dangerous conditions or equipment. This rule has been abolished by workers' compensation statutes in most states.

Act of God

Technically, the rule that no one is responsible for an "act of God," or *force majeure* as it is sometimes called, is not an excuse but a defense premised on a lack of causation. If a force of nature caused the harm, then the defendant was not negligent in the first place. A marina, obligated to look after boats moored at its dock, is not liable if a sudden and fierce storm against which no precaution was possible destroys someone's vessel. However, if it is foreseeable that harm will flow from a negligent condition triggered by a natural event, then there is liability. For example, a work crew failed to remove residue explosive gas from an oil barge. Lightning hit the barge, exploded the gas, and injured several workmen. The plaintiff recovered damages against the company because the negligence consisted in the failure to guard against any one of a number of chance occurrences that could ignite the gas. (*Johnson v. Kosmos Portland Cement Co.*, 64 F.2d 193 (6th Cir. 1933).)

Vicarious Liability

Liability for negligent acts does not always end with the one who was negligent. Under certain circumstances, the liability is imputed to others. For example, an employer is responsible for the negligence of her employees if they were acting in the scope of employment. This rule of vicarious liability is often called *respondeat superior*, meaning that the higher authority must respond to claims brought against one of its agents. Respondeat superior is not limited to the employment relationship but extends to a number of other agency relationships as well.

Legislatures in many states have enacted laws that make people vicariously liable for acts of certain people with whom they have a relationship, though not necessarily one of agency. It is common, for example, for the owner of an automobile to be liable for the negligence of one to whom the owner lends the car. So-called dram shop statutes place liability on bar and tavern owners and others who serve too much alcohol to one who, in an intoxicated state, later causes injury to others. In these situations, although the injurious act of the drinker stemmed from negligence, the one whom the law holds vicariously liable (the bartender) is not himself necessarily negligent—the law is holding him *strictly liable*, and to this concept we now turn.

Key Takeaway

The most common tort claim is based on the negligence of the defendant. In each negligence claim, the plaintiff must establish by a preponderance of the evidence that (1) the defendant had a duty of due care, (2) the defendant breached that duty, (3) that the

breach of duty both actually and approximately has caused harm to the plaintiff, and (4) that the harm is measurable in money damages.

It is also possible for the negligence of one person to be imputed to another, as in the case of respondeat superior, or in the case of someone who loans his automobile to another driver who is negligent and causes injury. There are many excuses (defenses) to claims of negligence, including assumption of risk and comparative negligence. In those few jurisdictions where contributory negligence has not been modified to comparative negligence, plaintiffs whose negligence contributes to their own injuries will be barred from any recovery.

Exercises

1. Explain the difference between comparative negligence and contributory negligence.
2. How is actual cause different from probable cause?
3. What is an example of assumption of risk?
4. How does res ipsa loquitur help a plaintiff establish a case of negligence?

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6.4: Strict Liability

Learning Objectives

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

- Understand how strict liability torts differ from negligent torts.
- Understand the historical origins of strict liability under common law.
- Be able to apply strict liability concepts to liability for defective products.
- Distinguish strict liability from absolute liability, and understand the major defenses to a lawsuit in products-liability cases.

Historical Basis of Strict Liability: Animals and Ultrahazardous Activities

To this point, we have considered principles of liability that in some sense depend upon the "fault" of the tortfeasor. This fault is not synonymous with moral blame.

Aside from acts intended to harm, the fault lies in a failure to live up to a standard of reasonableness or due care. But this is not the only basis for tort liability. Innocent mistakes can be a sufficient basis. As we have already seen, someone who unknowingly trespasses on another's property is liable for the damage that he does, even if he has a reasonable belief that the land is his. And it has long been held that someone who engages in ultrahazardous (or sometimes, abnormally dangerous) activities is liable for damage that he causes, even though he has taken every possible precaution to avoid harm to someone else.

Likewise, the owner of animals that escape from their pastures or homes and damage neighboring property may be liable, even if the reason for their escape was beyond the power of the owner to stop (e.g., a fire started by lightning that burns open a barn door). In such cases, the courts invoke the principle of strict liability, or, as it is sometimes called, liability without fault. The reason for the rule is explained in *Klein v. Pyrodyne Corporation* (Section 7.5).

Strict Liability for Products

Because of the importance of products liability, this text devotes an entire chapter to it (Chapter 9). Strict liability may also apply as a legal standard for products, even those that are not ultrahazardous. In some national legal systems, strict liability is not available as a cause of action to plaintiffs seeking to recover a judgment of products liability against a manufacturer, wholesaler, distributor, or retailer. (Some states limit liability to the manufacturer.) But it is available in the United States and initially was created by a California Supreme Court decision in the 1962 case of *Greenman v. Yuba Power Products, Inc.*

In *Greenman*, the plaintiff had used a home power saw and bench, the Shopsmith, designed and manufactured by the defendant. He was experienced in using power tools and was injured while using the approved lathe attachment to the Shopsmith to fashion a wooden chalice. The case was decided on the premise that Greenman had done nothing wrong in using the machine but that the machine had a defect that was "latent" (not easily discoverable by the consumer). Rather than decide the case based on warranties, or requiring that Greenman prove how the defendant had been negligent, Justice Traynor found for the plaintiff based on the overall social utility of strict liability in cases of defective products. According to his decision, the purpose of such liability is to ensure that the "cost of injuries resulting from defective products is borne by the manufacturers…rather than by the injured persons who are powerless to protect themselves."

Today, the majority of US states recognize strict liability for defective products, although some states limit strict liability actions to damages for personal injuries rather than property damage. Injured plaintiffs have to prove the product caused the harm but do not have to prove exactly how the manufacturer was careless. Purchasers of the product, as well as injured guests, bystanders, and others with no direct relationship with the product, may sue for damages caused by the product.

The Restatement of the Law of Torts, Section 402(a), was originally issued in 1964. It is a widely accepted statement of the liabilities of sellers of goods for defective products. The Restatement specifies six requirements, all of which must be met for a plaintiff to recover using strict liability for a product that the plaintiff claims is defective:

1. The product must be in a defective condition when the defendant sells it.
2. The defendant must normally be engaged in the business of selling or otherwise distributing the product.
3. The product must be unreasonably dangerous to the user or consumer because of its defective condition.

4. The plaintiff must incur physical harm to self or to property by using or consuming the product.
5. The defective condition must be the proximate cause of the injury or damage.
6. The goods must not have been substantially changed from the time the product was sold to the time the injury was sustained.

Section 402(a) also explicitly makes clear that a defendant can be held liable even though the defendant has exercised "all possible care." Thus in a strict liability case, the plaintiff does not need to show "fault" (or negligence).

For defendants, who can include manufacturers, distributors, processors, assemblers, packagers, bottlers, retailers, and wholesalers, there are a number of defenses that are available, including assumption of risk, product misuse and comparative negligence, commonly known dangers, and the knowledgeable-user defense. We have already seen assumption of risk and comparative negligence in terms of negligence actions; the application of these is similar in products-liability actions.

Under product misuse, a plaintiff who uses a product in an unexpected and unusual way will not recover for injuries caused by such misuse. For example, suppose that someone uses a rotary lawn mower to trim a hedge and that after twenty minutes of such use loses control because of its weight and suffers serious cuts to his abdomen after dropping it. Here, there would be a defense of product misuse, as well as contributory negligence. Consider the urban (or Internet) legend of Mervin Gratz, who supposedly put his Winnebago on autopilot to go back and make coffee in the kitchen, then recovered millions after his Winnebago turned over and he suffered serious injuries. There are multiple defenses to this alleged action; these would include the defenses of contributory negligence, comparative negligence, and product misuse. (There was never any such case, and certainly no such recovery; it is not known who started this legend, or why.)

Another defense against strict liability as a cause of action is the knowledgeable user defense. If the parents of obese teenagers bring a lawsuit against McDonald's, claiming that its fast-food products are defective and that McDonald's should have warned customers of the adverse health effects of eating its products, a defense based on the knowledgeable user is available. In one case, the court found that the high levels of cholesterol, fat, salt, and sugar in McDonald's food is well known to users. The court stated, "If consumers know (or reasonably should know) the potential ill health effects of eating at McDonald's, they cannot blame McDonald's if they, nonetheless, choose to satiate their appetite with a surfeit of supersized McDonald's products."(*Pellman v. McDonald's Corp.*, 237 F.2d 512 (S.D.N.Y. 2003).)

Key Takeaway

Common-law courts have long held that certain activities are inherently dangerous and that those who cause damage to others by engaging in those activities will be held strictly liable. More recently, courts in the United States have applied strict liability to defective products. Strict liability, however, is not absolute liability, as there are many defenses available to defendants in lawsuits based on strict liability, such as comparative negligence and product abuse.

Exercises

1. Someone says, "Strict liability means that you're liable for whatever you make, no matter what the consumer does with your product. It's a crazy system." Respond to and refute this statement.
2. What is the essential difference between strict liability torts and negligent torts? Should the US legal system even allow strict liability torts? What reasons seem persuasive to you?

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6.5: Summary and Exercises

Summary

The principles of tort law pervade modern society because they spell out the duties of care that we owe each other in our private lives. Tort law has had a significant impact on business because modern technology poses significant dangers and the modern market is so efficient at distributing goods to a wide class of consumers.

Unlike criminal law, tort law does not require the tortfeasor to have a specific intent to commit the act for which he or she will be held liable to pay damages. Negligence—that is, carelessness—is a major factor in tort liability. In some instances, especially in cases involving injuries caused by products, a no-fault standard called strict liability is applied.

What constitutes a legal injury depends very much on the circumstances. A person can assume a risk or consent to the particular action, thus relieving the person doing the injury from tort liability. To be liable, the tortfeasor must be the proximate cause of the injury, not a remote cause. On the other hand, certain people are held to answer for the torts of another—for example, an employer is usually liable for the torts of his employees, and a bartender might be liable for injuries caused by someone to whom he sold too many drinks. Two types of statutes—workers' compensation and no-fault automobile insurance—have eliminated tort liability for certain kinds of accidents and replaced it with an immediate insurance payment plan.

Among the torts of particular importance to the business community are wrongful death and personal injury caused by products or acts of employees, misrepresentation, defamation, and interference with contractual relations.

Exercises

1. What is the difference in objectives between tort law and criminal law?
2. A woman fell ill in a store. An employee put the woman in an infirmary but provided no medical care for six hours, and she died. The woman's family sued the store for wrongful death. What arguments could the store make that it was not liable? What arguments could the family make? Which seem the stronger arguments? Why?
3. The signals on a railroad crossing are defective. Although the railroad company was notified of the problem a month earlier, the railroad inspector has failed to come by and repair them. Seeing the all-clear signal, a car drives up and stalls on the tracks as a train rounds the bend. For the past two weeks the car had been stalling, and the driver kept putting off taking the car to the shop for a tune-up. As the train rounds the bend, the engineer is distracted by a conductor and does not see the car until it is too late to stop. Who is negligent? Who must bear the liability for the damage to the car and to the train?
4. Suppose in the *Katko v. Briney* case (Section 7.2) that instead of setting such a device, the defendants had simply let the floor immediately inside the front door rot until it was so weak that anybody who came in and took two steps straight ahead would fall through the floor and to the cellar. Will the defendant be liable in this case? What if they invited a realtor to appraise the place and did not warn her of the floor? Does it matter whether the injured person is a trespasser or an invitee?
5. Plaintiff's husband died in an accident, leaving her with several children and no money except a valid insurance policy by which she was entitled to $5,000. Insurance Company refused to pay, delaying and refusing payment and meanwhile "inviting" Plaintiff to accept less than $5,000, hinting that it had a defense. Plaintiff was reduced to accepting housing and charity from relatives. She sued the insurance company for bad-faith refusal to settle the claim and for the intentional infliction of emotional distress. The lower court dismissed the case. Should the court of appeals allow the matter to proceed to trial?

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CHAPTER OVERVIEW

7: Contracts

Learning Objectives

After reading this chapter, you should understand the following:

- What role contracts play in society today
- What a contract is
- The sources of contract law
- Some basic contract taxonomy
- The required elements of a contract: mutual assent, consideration, legality, and capacity
- The circumstances when a contract needs to be in writing to be enforceable
- The remedies for breach of contract

The two fundamental concepts considered the twin cornerstones of business relationships are contract and tort. Although both involve the concept of duty, creation of the duty differs in a manner that is important to business. The parties create *contract* duties through a bargaining process. The key element in the process is control; individuals are in control of a situation because they have the freedom to decide whether to enter into a contractual relationship. The importance of contracts cannot be overestimated in business relationships. *Tort* duties, in contrast, are obligations the law imposes. Despite the obvious difficulty in controlling tort liability, an understanding of tort theory is important because it is a critical factor in strategic planning and risk management. Now that

7.1: General Perspectives on Contracts

7.2: Contract Formation

7.3: Remedies

7.4: Summary and Exercises

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7.1: General Perspectives on Contracts

Learning Objectives

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

- Understand the role of contract in society: it moves society from status to contract.
- Know the definition of a contract.
- Recognize the sources of contract law: the common law, the UCC, and the Convention on the International Sale of Goods —a treaty (the CISG).
- Understand some fundamental contract taxonomy and terminology.

The Role of Contract in Society

Contract is probably the most familiar legal concept in our society because it is so central to a deeply held conviction about the essence of our political, economic, and social life. In common language, the term is used interchangeably with agreement, bargain, undertaking, or deal; but whatever the word, it embodies our notion of freedom to pursue our own lives together with others. Contract is central because it is the means by which a free society orders what would otherwise be a jostling, frenetic anarchy. So commonplace is the concept of contract—and our freedom to make contracts with each other—that it is difficult to imagine a time when contracts were rare, an age when people's everyday associations with one another were not freely determined. Yet in historical terms, it was not so long ago that contracts were rare, entered into if at all by very few. In "primitive" societies and in the medieval Europe from which our institutions sprang, the relationships among people were largely fixed; traditions spelled out duties that each person owed to family, tribe, or manor. Though he may have oversimplified, Sir Henry Maine, a nineteenth-century historian, sketched the development of society in his classic book *Ancient Law. As* he put it:

(F)rom a condition of society in which all the relations of Persons are summed up in the relations of Family, we seem to have steadily moved towards a phase of social order in which all these relations arise from the free agreement of Individuals. . . . Thus the status of the Slave has disappeared—it has been superseded by the contractual relation of the servant to his master. . . . The status of the Female under Tutelage . . . has also ceased to exist. . . . So too the status of the Son under Power has no true place in the law of modern European societies. If any civil obligation binds together the Parent and the child of full age, it is one to which only contract gives its legal validity…. If then we employ Status, agreeably with the usage of the best writers, to signify these personal conditions [arising from ancient legal privileges of the Family] only, we may say that the movement of the progressive societies has hitherto been a movement from Status to Contract.

This movement was not accidental. It went hand-in-glove with the emerging industrial order; from the fifteenth to the nineteenth centuries, as England, especially, evolved into a booming mercantile economy with all that that implies—flourishing trade, growing cities, an expanding monetary system, commercialization of agriculture, mushrooming manufacturing—contract law was created of necessity.

Contract law did not develop, however, according to a conscious, far-seeing plan. It was a response to changing conditions, and the judges who created it frequently resisted, preferring the quieter, imagined pastoral life of their forefathers. Not until the nineteenth century, in both the United States and England, did a full-fledged law of contracts arise together with modem capitalism.

Contract Defined

As usual in the law, the legal definition of "contract" is formalistic. The Restatement says: "A contract is a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty." *(Restatement* (Second) *of Contracts,* Section 1.) Similarly, the Uniform Commercial Code says: "'Contract' means the total legal obligation which results from the parties' agreement as affected by this Act and any other applicable rules of law." (Section 1-201(11).) A short-hand definition is: "A contract is a legally enforceable promise."

Economic View of Contract Law

In *An Economic Analysis of Law* (1973), Judge Richard A. Posner, a former University of Chicago law professor and widely-recognized authority in law and economics, suggests that contract law performs three significant economic functions. First, it helps

maintain incentives to individuals to exchange goods and services efficiently. Second, it reduces the costs of economic transactions because its very existence means that the parties need not go to the trouble of negotiating a variety of rules and terms already spelled out. Third, the law of contracts alerts the parties to trouble spots that have arisen in the past, thus making it easier to plan the transactions more intelligently and avoid potential pitfalls.

Sources of Contract Law

There are four basic sources of contract law: 1) the Constitution; 2) federal and state statutes; 3) federal and state case law; and, 4) administrative law. For our purposes, the most important of these are case law and statutes.

Case (Common) Law and the Restatement of Contracts

Because contract law was forged in the common-law courtroom, hammered out case by case on the anvil of individual judges, it grew in the course of time to formidable proportions. By the early twentieth century, tens of thousands of contract disputes had been submitted to the courts for resolution, and the published opinions, if collected in one place, would have filled dozens of bookshelves. Clearly this mass of case law was too unwieldy for efficient use. A similar problem had developed in the other leading branches of the common law. Disturbed by the profusion of cases and the resulting uncertainty of the law, a group of prominent American judges, lawyers, and teachers founded the American law Institute in 1923 to attempt to clarify, simplify, and improve the law. One of its first projects, and ultimately one of its most successful, was the drafting of the Restatement of the Law of Contracts, completed in 1932. A revision—the *Restatement (Second) of Contracts*—was undertaken in 1946 and finally completed in 1979.

The Restatements (others exist in the fields of torts, agency, conflicts of laws, judgments, property, restitution, security, and trusts) are detailed analyses of the decided cases in the field. These analyses are made with an eye to discerning the various principles that have emerged from the courts, and to the maximum extent possible, the Restatements declare the law as the courts have determined it to be. The Restatements, guided by a Reporter (the director of the project) and a staff of legal scholars, go through several so-called “tentative” drafts—sometimes as many as fifteen or twenty—and are screened by various committees within the American Law Institute before they are eventually published as final documents.

The *Restatement of Contracts* won prompt respect in the courts and has been cited in innumerable cases. The Restatements are not authoritative, in the sense that they are not actual judicial precedents, but they are nevertheless weighty interpretive texts, and judges frequently look to them for guidance. They are as close to “black letter” rules of law as exist anywhere in the American legal system for judge-made (common) law.

Statutory Law: The Uniform Commercial Code

Common law contract principles govern contracts for real estate and for services, obviously very important areas of law. But in one area the common law has been superseded by an important statute: the Uniform Commercial Code (UCC), especially Article 2, which deals with the sale of goods.

A Brief History

The UCC is a model law developed by the American law Institute and the National Conference of Commissioners on Uniform State Laws; it has been adopted in one form or another in all fifty states, the District of Columbia, and the American territories. It is the only “national” law not enacted by Congress. In California, the UCC is largely incorporated into the California Commerical Code.

Before the UCC was written, commercial law varied, sometimes greatly, from state to state. This first proved a nuisance and then a serious impediment to business as the American economy became nationwide during the twentieth century. Although there had been some uniform laws concerned with commercial deals—including the Uniform Sales Act, first published in 1906—few were widely adopted and none nationally. As a result, the law governing sales of goods, negotiable instruments, warehouse receipts, securities, and other matters crucial to doing business in an industrial, market economy was a crazy quilt of untidy provisions that did not mesh well from state to state.

Initial drafting of the UCC began in 1942 and was ten years in the making, involving the efforts of hundreds of practicing lawyers, law teachers, and judges. A final draft, promulgated by the Institute and the Conference, was endorsed by the American Bar Association and published in 1951. Over the course of approximately 30 years, states began to adopt the UCC and the UCC was

modified to accommodate individual state contributions. The UCC has now been adopted by all states, but continues to evolve to reflect changes in market conditions and technology. The latest UCC amendments were made in 2022 to provide rules relating to electronic records and cryptocurrency.

The Basic Framework of the UCC

The UCC embraces the concept of "commercial transactions," a term of some ambiguity. A commercial transaction may seem to be a series of separate transactions; it may include, for example, the making of a contract for the sale of goods, the signing of a check, the endorsement of the check, the shipment of goods under a bill of Lading, and so on. However, the UCC presupposes that each of these transactions is a facet of one single transaction: the sale of and payment for goods. The Code deals with phases of this transaction from start to finish. These phases are organized according to the following "articles":

- *Sales* (Article 2)
- *Commercial Paper* (Article 3)
- *Bank Deposits and Collections* (Article 4)
- *Letters of Credit* (Article 5)
- *Bulk Transfers* (Article 6)
- *Warehouse Receipts, Bills of Lading, and Other Documents of Title* (Article 7)
- *Investment Securities* (Article 8)
- *Secured Transactions; Sales of Accounts and Chattel Paper* (Article 9)

We now turn our attention to the sale—the first facet, and the cornerstone, of the commercial transaction. Sales law is a special type of contract law in that Article 2 applies only to the sale of goods, defined (Section 2-105) in part as "all things . . . which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid. . . ." The only contracts and agreements covered by Article 2 are those relating to the present or future sale of goods.

In certain cases, the courts have difficulty in determining the nature of the object of a sales contract. The problem: How can goods and services be separated in contracts calling for the seller to deliver a combination of goods and services? This difficulty frequently arises in product liability cases in which the buyer sues the seller for breach of one of the UCC warranties. For example, you go to the hairdresser for a permanent and the shampoo gives you a severe scalp rash. May you recover damages on the grounds that either the hairdresser or the manufacturer breached an implied warranty in the sale of goods?

When the goods used are incidental to the service, the courts are split on whether the plaintiff should win. Compare *Epstein* v. *Giannattasio,* 197 A.2d 342 (Conn. 1963), in which the court held that no sale of goods had been made because the plaintiff received a treatment in which the cosmetics were only incidentally used, with *Newmark* v. *Gimbel's Inc.,* 258 A.2d 697 (N.J. 1969), in which the court said "[i]f the permanent wave lotion were sold … for home consumption . . . unquestionably an implied warranty of fitness for that purpose would have been an integral incident of the sale." The New Jersey court rejected the defendant's argument that by actually applying the lotion to the patron's head the salon lessened the liability it otherwise would have had if it had simply sold her the lotion.

In two areas, state legislatures have taken the goods vs. services issue out of the courts' hands and resolved the issue through legislation. One area involves restaurant cases, in which typically the plaintiff charges that he became ill because of tainted food. UCC Section 2·314(1) states that any seller who is regularly a merchant of the goods sold impliedly warrants their merchantability in a contract for their sale. This section explicitly declares that serving food or drink is a sale, whether they are to be consumed on or off the premises.

The second type of case involves blood transfusions, which can give a patient hepatitis, a serious and sometimes fatal disease. Hospitals and blood banks obviously face large potential liability under the UCC provision just referred to on implied warranty of merchantability. Because medical techniques cannot detect the hepatitis virus in any form of blood used, hospitals and blood banks would be in constant jeopardy, without being able to take effective action to minimize the danger. Most states have enacted legislation specifically providing that blood supplies to be used in transfusions are a service, not goods, thus relieving the suppliers and hospitals of an onerous burden.

Three Basic Contract Types: Sources of Law

With this brief description of the UCC, it should now be clear that the primary sources of law for the three basic types of contracts are:

- Real estate: common law;
- Services: common law;
- Sale of goods: UCC (as interpreted by the courts).

Common law and UCC rules are often similar. For example, both require good faith in the performance of a contract. However, there are two general differences worth noting between the common law of contracts and the UCC's rules governing the sales of goods. First, the UCC is more liberal than the common law in upholding the existence of a contract. For example, in a sales contract (covered by the UCC), "open" terms—that is, those the parties have not agreed upon—do not require a court to rule that no contract was made. However, open terms in a *nonsales* contract will frequently result in a ruling that there is no contract. Second, although the common law of contracts applies to every person equally, under the UCC "merchants" occasionally receive special treatment. By "merchants" the UCC means persons who have special knowledge or skill who deal in the goods involved in the transaction.

The Convention on Contracts for the International Sale of Goods

A Convention on Contracts for the International Sale of Goods (CISG) was approved in 1980 at a diplomatic conference in Vienna. (A convention is a preliminary agreement that serves as the basis for a formal treaty.) The Convention has been adopted by several countries, including the United States.

The Convention is significant for three reasons. First, the Convention is a uniform law governing the sale of goods—in effect, an international Uniform Commercial Code. The major goal of the drafters was to produce a uniform law acceptable to countries with different legal, social and economic systems. Second, although provisions in the Convention are generally consistent with the UCC, there are significant differences. For instance, under the Convention, consideration (discussed below) is not required to form a contract and there is no Statute of Frauds (a requirement that some contracts be evidenced by a writing to be enforceable—also discussed below). Finally, the Convention represents the first attempt by the US Senate to reform the private law of business through its treaty powers, for the Convention preempts the UCC if the parties to a contract elect to use the CISG.

Basic Contract Taxonomy

Contracts are not all cut from the same die. Some are written, some oral; some are explicit, some not. Because contracts can be formed, expressed, and enforced in a variety of ways, a taxonomy of contracts has developed that is useful in lumping together like legal consequences. In general, contracts are classified along these dimensions: explicitness, mutuality, enforceability, and degree of completion. **Explicitness** is concerned with the degree to which the agreement is manifest to those not party to it. **Mutuality** takes into account whether promises are exchanged by two parties or only one. **Enforceability** is the degree to which a given contract is binding. **Completion** considers whether the contract is yet to be performed or the obligations have been fully discharged by one or both parties. We will examine each of these concepts in turn.

Explicitness

Express Contract

An express contract is one in which the terms are spelled out directly; the parties to an express contract, whether written or oral, are conscious that they are making an enforceable agreement. For example, an agreement to purchase your neighbor's car for $500 and to take title next Monday is an express contract.

Implied Contract

An implied contract is one that is inferred from the actions of the parties. Although no discussion of terms took place, an implied contract exists if it is clear from the conduct of both parties that they intended there be one. A delicatessen patron who asks for a "turkey sandwich to go" has made a contract and is obligated to pay when the sandwich is made. By ordering the food, the patron is implicitly agreeing to the price, whether posted or not.

Contract Implied in Law: Quasi-contract

Both express and implied contracts embody an actual agreement of the parties. A quasi-contract, by contrast, is an obligation said to be ‘‘imposed by law” in order to avoid unjust enrichment of one person at the expense of another. In fact, a quasi-contract is not a contract at all; it is a fiction that the courts created to prevent injustice. Suppose, for example, that a carpenter mistakenly believes you have hired him to repair your porch; in fact, it is your neighbor who has hired him. One Saturday morning he arrives at your doorstep and begins to work. Rather than stop him, you let him proceed, pleased at the prospect of having your porch fixed for free (since you have never talked to the carpenter, you figure you need not pay his bill). Although it is true there is no contract, the law implies a contract for the value of the work.

Mutuality

The garden-variety contract is one in which the parties make mutual promises. Each is both promisor and promisee; that is, each pledges to do something and each is the recipient of such a pledge. This type of contract is called a bilateral contract. But mutual promises are not necessary to constitute a contract. Unilateral contracts, in which only one party makes a promise, are equally valid but depend upon performance of the promise to be binding. If Charles says to Fran, “I will pay you five dollars if you wash my car,” Charles is contractually bound to pay once Fran washes the car. Fran never makes a promise, but by actually performing she makes Charles liable to pay. A common example of a unilateral contract is the offer “$50 for the return of my lost dog.” Frances never makes a promise to the offeror, but if she looks for the dog and finds it, she is entitled to the $50.

Enforceability

Not every agreement between two people is a binding contract. An agreement that is lacking one of the legal elements of a contract is said to be void—that is, not a contract at all. An agreement that is illegal—for example, a promise to commit a crime in return for a money payment—is void. Neither party to a void “contract” may enforce it.

By contrast, a voidable contract is one that is unenforceable by one party but enforceable by the other. For example, a minor (any person under eighteen, in most states) may “avoid” a contract with an adult; the adult may not enforce the contract against the minor, if the minor refuses to carry out the bargain. But the adult has no choice if the minor wishes the contract to be performed. (A contract may be voidable by both parties if both are minors.) Ordinarily, the parties to a voidable contract are entitled to be restored to their original condition. Suppose you agree to buy your seventeen-year-old neighbor’s car. He delivers it to you in exchange for your agreement to pay him next week. He has the legal right to terminate the deal and recover the car, in which case you will of course have no obligation to pay him. If you have already paid him, he still may legally demand a return to the *status quo ante* (previous state of affairs). You must return the car to him; he must return the cash to you.

A voidable contract remains a valid contract until it is voided. Thus, a contract with a minor remains in force unless the minor decides he does not wish to be bound by it. When the minor reaches his majority, he may “ratify” the contract—that is, agree to be bound by it-in which case the contract will no longer be voidable and will thereafter be fully enforceable.

An unenforceable contract is one that some rule of law bars a court from enforcing. For example, Tom owes Pete money, but Pete has waited too long to collect it and the statute of limitations has run out. The contract for repayment is unenforceable and Pete is out of luck, unless Tom makes a new promise to pay or actually pays part of the debt. (However, if Pete is holding collateral as security for the debt, he is entitled to keep it; not all rights are extinguished because a contract is unenforceable.)

Degree of Completion

In medieval England, contract—defined as set of promises—was not an intuitive concept. The courts gave relief to one who wanted to collect a debt, for in such a case the creditor presumably had already given the debtor something of value, and the failure of the debtor to pay up was seen as manifestly unjust. But the issue was less clear when neither promise had yet been fulfilled. Suppose John agrees to sell Humphrey a quantity of wheat in one month. On the appointed day, Humphrey refuses to take the wheat or to pay. The modem law of contracts holds that a valid contract exists and that Humphrey is required to pay John.

An agreement consisting of a set of promises is called an executory contract before either promise is carried out. Most executory contracts are enforceable. If one promise or set of terms has been fulfilled—if, for example, John had delivered the wheat to Humphrey—the contract is called partially executed. A contract that has been carried out fully by both parties is called an executed contract.

Key Takeaways

Contract is the mechanism by which people in modern society make choices for themselves, as opposed to being born or placed into a status as is common in feudal societies. A contract is a legally enforceable promise. The law of contract is the common law (for contracts involving real estate and services), statutory law (the Uniform Commercial Code for contract involving the sale or leasing of goods), and treaty law (the Convention on the International Sale of Goods). Contracts may be described based on the degree of their explicitness, mutuality, enforceability, and degree of completion.

Exercises

1. What did Sir Henry Maine mean when he wrote of society's movement "from status to contract?
2. Are all promises "contracts"?
3. What is the source of law for contracts involving real estate? For contracts involving the sale of goods?
4. In contract taxonomy, what are the degrees of explicitness, mutuality, enforceability, and of completion?

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7.2: Contract Formation

Learning Objectives

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

- Understand the elements of common-law contracts: mutuality of agreement (offer and acceptance), consideration, legality, and capacity.
- Learn when a contract must be in writing—or evidenced by some writing—to be enforceable.

Although it has countless wrinkles and nuances, contract law asks two principal questions: did the parties create a valid, enforceable contract? What remedies are available when one party breaks the contract? The answer to the first question is not always obvious; the range of factors that must be taken into account can be large and their relationship subtle. Since people in business frequently conduct contract negotiations without the assistance of a lawyer, it is important to attend to the nuances to avoid legal trouble at the outset. Whether a valid enforceable contract has been formed depends in turn on whether:

1. The parties reached an agreement (offer and acceptance);
2. Consideration was present (some price was paid for what was received in return);
3. The agreement was legal; and,
4. The parties entered into the contract with capacity to make a contract;

The Agreement: Offer and Acceptance

The core of a legal contract is the agreement between the parties. That is not merely a matter of convenience; it is at the heart of our received philosophical and psychological beliefs. As the great student of contract law, Samuel Williston, put it:

It was a consequence of the emphasis laid on the ego and the individual will that the formation of a contract should seem impossible unless the wills of the parties concurred. Accordingly we find at the end of the eighteenth century, and the beginning of the nineteenth century, the prevalent idea that there must be a "meeting of the minds" (a new phrase) in order to form a contract.

Although agreements may take any form, including unspoken conduct between the parties (UCC Section 2-204(1)), they are usually structured in terms of an *offer* and an *acceptance*. Note, however, that not every agreement, in the broadest sense of the word, need consist of an offer and acceptance, and it is entirely possible, therefore, for two persons to reach agreement without forming a contract. For example, people may agree that the weather is pleasant or that it would be preferable to go out for Chinese food rather than seeing a foreign film; in neither case has a contract been formed. One of the major functions of the law of contracts is to sort out those agreements that are legally binding—those that are contracts—from those that are not.

In interpreting agreements, courts generally apply an objective standard. The *Restatement (Second) of Contracts* defines agreement as a "*manifestation* of mutual assent by two or more persons to one another." (Section 3) The UCC defines agreement as "the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance." (Section 1-201(3).) The critical question is what the parties said or did, not what they thought they said or did.

The distinction between objective and subjective standards crops up occasionally when one person claims he spoke in jest. The vice president of a manufacturer of punchboards, used in gambling, testified to the Washington State Game Commission that he would pay $100,000 to anyone who found a "crooked board." Barnes, a bartender, who had purchased two that were crooked some time before, brought one to the company office, and demanded payment. The company refused, claiming that the statement was made in jest (the audience before the commission had laughed when the offer was made). The court disagreed, holding that it was reasonable to interpret the pledge of $100,000 as a means of promoting punchboards:

(I)f the jest is not apparent and a reasonable hearer would believe that an offer was being made, then the speaker risks the formation of a contract which was not intended. It is the objective manifestations of the offeror that count and not secret, unexpressed intentions. If a party's words or acts, judged by a reasonable standard, manifest an intention to agree in regard to the matter in question, that agreement is established, and it is immaterial what may be the real but unexpressed state of the party's mind on the subject.

(Barnes v. Treece, 549 P.2d 1152 (Wash. App. 1976).)

An offer is a manifestation of willingness to enter into a bargain such that it would be reasonable for another individual to conclude that assent to the offer would complete the bargain. Offers must be communicated and must be definite; that is, they must spell out terms to which the offeree can assent.

To constitute an agreement, there must be an acceptance of the offer. The offeree must manifest his assent to the terms of the offer in a manner invited or required by the offer. Complications arise when an offer is accepted indirectly through correspondence. Although offers and revocations of offers are not effective until received, an acceptance is deemed accepted when sent if the offeree accepts in the manner specified by the offeror.

If the offeror specifies no particular mode, then acceptance is effective when transmitted as long as the offeree uses a reasonable method of acceptance. It is implied that the offeree can use the same means used by the offeror or a means of communication customary to the industry. For example, the use of the postal service was so customary that acceptances are considered effective when mailed, regardless of the method used to transmit the offer. Indeed, the so-called "mailbox rule" (the acceptance is effective upon dispatch) has an ancient lineage, tracing back nearly two hundred years to the English courts. (*Adams v. Lindsell*, 1 Bamewall & Alderson 681 (K.B. 1818).)

Consideration

Consideration, is the quid pro quo (something given or received for something else) between the contracting parties in the absence of which the law will not enforce the promise or promises made. Consider the following three "contracts":

1. Betty offers to give a book to Lou. Lou accepts.
2. Betty offers Lou the book in exchange for Lou's promise to pay $15. Lou accepts.
3. Betty offers to give Lou the book if Lou promises to pick it up at Betty's house. Lou accepts.

The question is which, if any, is a binding contract? In American law, as explained more fully below, only situation 2 is a binding contract because only that contract contains a set of mutual promises in which each party pledges to give up something to the benefit of the other.

The question of what constitutes a binding contract has been answered differently throughout history and in other cultures. For example, under Roman law, any contract that was reduced to writing was binding, whether or not there was consideration in our sense. Moreover, in later Roman times, certain promises of gifts were made binding, whether written or oral; these would not be binding in the United States. And in the Anglo-American tradition, the presence of a seal was once sufficient to make a contract binding without any other consideration. In most states, the seal is no longer a substitute for consideration, although in some states it creates a presumption of consideration. The Uniform Commercial Code has abolished the seal on contracts for the sale of goods.

The existence of consideration is determined by examining whether the person against whom a promise is to be enforced (the promisor) received something in return from the person to whom he made the promise (the promisee). That may seem a simple enough question. But as with much in the law, the complicating situations are never very far away. The "something" that is promised or delivered cannot just be anything: a feeling of pride, warmth, amusement, friendship; it must be something known as a legal detriment—an act, a forbearance, or a promise of such from the promisee. The detriment need not be an actual detriment; it may in fact be a benefit to the promisee, or at least not a loss. At the same time, the "detriment" to the promisee need not confer a tangible benefit on the promisor; the promisee can agree to forego something without that something being given to the promisor. Whether consideration is legally sufficient has nothing to do with whether it is morally or economically adequate to make the bargain a fair one. Moreover, legal consideration need not even be certain; it can be a promise contingent on an event that may never happen. Consideration is a *legal* concept, and it centers on the giving up of a *legal* right or benefit.

Consideration has two elements. The first, as just outlined, is whether the promisee has incurred a legal detriment. (Some courts—although a minority—take the view that a bargained-for legal benefit to the promisor is sufficient consideration.) The second is whether the legal detriment was *bargained for*: did the promisor specifically intend the act, forbearance, or promise in return for his promise? Applying this two-pronged test to the three examples given at the outset of the chapter, we can easily see why only in the second is there legally sufficient consideration. In the first, Lou incurred no legal detriment; he made no pledge to act or to forbear from acting, nor did he in fact act or forbear from acting. In the third example, what might appear to be such a promise is not really

so. Betty made a promise on a condition that Lou come to her house; the intent clearly is to make a gift. Betty was not seeking to induce Lou to come to her house by promising the book.

There is a widely recognized exception to the requirement of consideration. In cases of promissory estoppel, the courts will enforce promises without consideration. Simply stated, promissory estoppel means that the courts will stop the promisor from claiming that there was no consideration. The doctrine of promissory estoppel is invoked in the interests of justice when three conditions are met: (1) the promise is one that the promisor should reasonably expect to induce the promisee to take action or forbear from taking action of a definite and substantial character; (2) the action or forbearance is taken; and (3) injustice can be avoided only by enforcing the promise.

Timko served on the board of trustees of a school. He recommended that the school purchase a building for a substantial sum of money, and to induce the trustees to vote for the purchase, he promised to help with the purchase and to pay at the end of five years the purchase price less the down payment. At the end of four years, Timko died. The school sued his estate, which defended on the ground that there was no consideration for the promise. Timko was promised or given nothing in return, and the purchase of the building was of no direct benefit to him (which would have made the promise enforceable as a unilateral contract). The court ruled that under the three-pronged promissory estoppel test, Timko's estate was liable. (*Estate of Timko v. Oral Roberts Evangelistic Assn.*, 215 N.W.2d 750 (Mich. App. 1974).)

Illegality

In general, illegal contracts are unenforceable. The courts must grapple with two types of illegalities: (1) statutory violations (e.g., the practice of law by a non-lawyer is forbidden by statute), and (2) violations of public policy not expressly declared unlawful by statute, but so declared by the courts.

Capacity

A contract is a meeting of minds. If someone lacks mental capacity to understand what he is assenting to—or that he is assenting to anything—it is unreasonable to hold him to the consequences of his act.

The general rule is that persons younger than eighteen can avoid their contracts. Although the age of majority was lowered in most states during the 1970s to correspond to the Twenty-sixth Amendment (ratified in 1971, guaranteeing the right to vote at eighteen), some states still put the age of majority at twenty-one. Legal rights for those under twenty-one remain ambiguous, however. Although eighteen-year-olds may assent to binding contracts, not all creditors and landlords believe it, and they may require parents to cosign. For those under twenty-one, there are also legal impediments to holding certain kinds of jobs, signing certain kinds of contracts, marrying, leaving home, and drinking alcohol. There is as yet no uniform set of rules.

The exact day on which the disability of minority vanishes also varies. The old common law rule put it on the day before the twenty-first birthday. Many states have changed this rule so that majority commences on the day of the eighteenth (or twenty-first) birthday.

A minor's contract is voidable, not void. A child wishing to avoid the contract need do nothing positive to disaffirm; the defense of minority to a lawsuit is sufficient. Although the adult cannot enforce the contract, the child can (which is why it is said to be voidable, not void).

When the minor becomes an adult, he has two choices: he may ratify the contract or disaffirm it. She may ratify explicitly; no further consideration is necessary. She may also do so by implication—for instance, by continuing to make payments or retaining goods for an unreasonable period of time. (In some states, a court may ratify the contract before the child becomes an adult. In California, for example, a state statute permits a movie producer to seek court approval of a contract with a child actor in order to prevent the child from disaffirming it upon reaching majority and suing for additional wages. As quid pro quo, the court can order the producer to pay a percentage of the wages into a trust fund that the child's parents or guardians cannot invade.) If the child has not disaffirmed the contract while still a minor, she may do so within a reasonable time after reaching majority.

In most cases of disavowal, the only obligation is to return the goods (if he still has them) or repay the consideration (unless it has been dissipated). However, in two situations, a minor might incur greater liability: contracts for necessities and misrepresentation of age.

Contract for Necessities

At common law, a "necessity" was defined as an essential need of a human being: food, medicine, clothing, and shelter. In recent years, however, the courts have expanded the concept, so that in many states today necessities include property and services that will enable the minor to earn a living and to provide for those dependent on him. If the contract is executory, the minor can simply disaffirm. If the contract has been executed, however, the minor must face more onerous consequences. Although he will not be required to perform under the contract, he will be liable under a theory of "quasi-contract" for the reasonable value of the necessity.

Misrepresentation of Age

In most states, a minor may misrepresent his age and disaffirm in accordance with the general rule, because that's what kids do, misrepresent their age. That the adult reasonably believed the minor was also an adult is of no consequence in a contract suit. But some states have enacted statutes that make the minor liable in certain situations. A Michigan statute, for instance, prohibits a minor from disaffirming if he has signed a "separate instrument containing only the statement of age, date of signing and the signature:" And some states "estop" him from claiming to be a minor if he falsely represented himself as an adult in making the ·contract. "Estoppel" is a refusal by the courts on equitable grounds to listen to an otherwise valid defense; unless the minor can return the consideration, the contract will be enforced.

Contracts made by an *insane* or *intoxicated* person are also said to have been made by a person lacking capacity. In general, such contracts are voidable by the person when capacity is regained (or by the person's legal representative if capacity is not regained).

Form

As a general rule, a contract need not be in writing to be enforceable. An oral agreement to pay a high-fashion model $1 million to pose for a photograph is as binding as if the language of the deal were printed on vellum and signed in the presence of twenty bishops. For centuries, however, a large exception has grown up around the Statute of Frauds, first enacted in England in 1677 under the formal name "An Act for the Prevention of Frauds and Perjuries." The purpose of the Statute of Frauds is to prevent the fraud that occurs when one party attempts to impose upon another a contract that did not in fact exist.

The Statute of Frauds is now considered a general term for circumstances where a writing is required to establish the existence of a binding contract. In the twentieth century Section 7 was been replaced by a section Uniform Commercial Code. The UCC requires contracts for the sale of goods for $500 or more and for the sale of securities to be in writing. In California, contracts that must be in writing include agreements that cannot be performed within one year, real estate contracts, promises to pay the debt of another, and loans exceeding $99,999. (Cal. Civ. Code, § 1624.)

Key Takeaways

A contract requires mutuality—an offer and an acceptance of the offer; it requires consideration—a "price" paid for what is obtained; it requires that the parties to the contract have legal capacity to know what they are doing; it requires legality. Certain contracts—governed by the statute of frauds—are required to be evidenced by some writing, signed by the party to be bound. The purpose here is to avoid the fraud that occurs when one person attempts to impose upon another a contract that did not really exist.

Exercises

1. What are the required elements of a contract?
2. When was the Statute of Frauds first enacted, by whom, and why?
3. Basically, what does the Statute of Frauds require?

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7.3: Remedies

Learning Objectives

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

- Know the types of damages: compensatory and punitive.
- Understand specific performance as a remedy.
- Understand restitution as a remedy.
- Recognize the interplay between contract and tort as a cause of action.

Monetary awards (called “damages”), specific performance, and restitution are the three principle remedies.

In view of the importance given to the intention of the parties in forming and interpreting contracts, it may seem surprising that the remedy for every breach is not a judicial order that the obligor carry out his undertakings. But it is not. Of course, some duties cannot be performed after a breach: time and circumstances will have altered their purpose and rendered many worthless. Still, although there are numerous occasions on which it would be theoretically possible for courts to order the parties to carry out their contracts, the courts will not do it. In 1897, Justice Oliver Wendell Holmes, Jr., declared in a famous line that “the duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it.” By that he meant simply that the common law looks more toward compensating the promisee for his loss than toward compelling the promisor to perform—a person always has the power, though not the right, to breach a contract. Indeed, the law of remedies often provides the parties with an incentive to break the contract. In short, the promisor has a choice: to perform or pay. The purpose of contract remedies is, for the most part, to compensate the non-breaching party for the losses suffered—to put the non-breaching party in the position he, she, or it would have been in had there been no breach.

Compensatory Damages

One party has the right to damages (money) when the other party has breached the contract unless, of course, the contract itself or other circumstances suspend or discharge that right. Compensatory damages is the general category of damages awarded to make the non-breaching party whole.

Consequential Damages

A basic principle of contract law is that a person injured by breach of contract is not entitled to compensation unless the breaching party, at the time the contract was made, had reason to foresee the loss as a probable result of the breach. The leading case, perhaps the most studied case in all the common law, is *Hadley* v. *Baxendale*, decided in England in 1854. Joseph and Jonah Hadley were proprietors of a flour mill in Gloucester. In May 1853, the shaft of the milling engine broke, stopping all milling. An employee went to Pickford and Company, a common carrier, and asked that the shaft be sent as quickly as possible to a Greenwich foundry that would use the shaft as a model to construct a new one. The carrier’s agent promised delivery within two days. But through an error the shaft was shipped by canal rather than by rail and did not arrive in Greenwich for seven days. The Hadleys sued Joseph Baxendale, managing director of Pickford, for the profits they lost because of the delay. In ordering a new trial, the court ruled that Baxendale was not liable because he had had no notice that the mill was stopped:

Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it.

(*Hadley v. Baxendale*, 9 Ex. 341, 354, 156 Eng.Rep. 145, 151 (1854).)

This sub-set of compensatory damages is called consequential damages—damages that flow as a foreseeable consequence of the breach. For example, if you hire a roofer to fix a leak in your roof, and he does a bad job so that the interior of your house suffers water damage, the roofer is liable not only for the poor roofing job, but also for the ruined drapes, damaged flooring and walls, and so on.

Nominal Damages

If the breach caused no loss, the plaintiff is nevertheless entitled to a minor sum, perhaps one dollar, called nominal damages. When, for example, a buyer could purchase the same commodity at the same price as that contracted for, without spending any extra time or money, there can be no real damages in the event of breach.

Incidental Damages

Suppose City College hires Prof. Blake on a two-year contract, after an extensive search. After one year the professor quits to take a job elsewhere, in breach of her contract. If City College has to pay $5000 more to find a replacement for year, Blake is liable for that amount—that's compensatory damages. But what if it costs City College $1200 to search for, bring to campus and interview a replacement? City College can claim that, too, as incidental damages which include additional costs incurred by the non-breaching party after the breach in a reasonable attempt to avoid further loss, even if the attempt is unsuccessful.

Punitive Damages

Punitive damages are those awarded for the purpose of punishing a defendant in a civil action, in which criminal sanctions may be unavailable. They are not part of the compensation for the loss suffered; they are proper in cases in which the defendant has acted willfully and maliciously and are thought to deter others from acting similarly. Since the purpose of contract law is compensation, not punishment, punitive damages have not traditionally been awarded, with one exception: when the breach of contract is also a tort for which punitive damages may be recovered. Punitive damages are permitted in the law of torts (in most states) when the behavior is malicious or willful (reckless conduct causing physical harm, deliberate defamation of one's character, a knowingly unlawful taking of someone's property), and some kinds of contract breach are also tortuous—for example, when a creditor holding collateral as security under a contract for a loan sells the collateral to a good-faith purchaser for value even though the debtor was not in default, he has breached the contract and committed the tort of conversion. Punitive damages may be awarded, assuming the behavior was willful and not merely mistaken.

Punitive damages are not fixed by law. The judge or jury may award at its discretion whatever sum is believed necessary to redress the wrong or deter like conduct in the future. This means that a richer person may be slapped with much heavier punitive damages than a poorer one in the appropriate case. But the judge in all cases may remit (lower) some or all of a punitive damage award if he or she considers it excessive.

Punitive damage claims have been made in cases dealing with the refusal by insurance companies to honor their contracts. Many of these cases involve disability payments, and among the elements are charges of tortious conduct by the company's agents or employees. California has been the leader among the state courts in their growing willingness to uphold punitive damage awards despite insurer complaints that the concept of punitive damages is but a device to permit plaintiffs to extort settlements from hapless companies. Courts have also awarded punitive damages against other types of companies for breach of contract.

Specific Performance

Specific performance is a judicial order to the promisor that he undertake the performance to which he obligated himself in a contract. Specific performance is an alternative remedy to damages and may be issued at the discretion of the court, subject to a number of exceptions. (When the promisee is seeking enforcement of a contractual provision for forbearance—a promise that the promisor will refrain from doing something—an injunction, a judicial order not to act in a specified manner, may be the appropriate remedy.) Emily signs a contract to sell Charlotte a gold samovar, a Russian antique of great sentimental value because it once belonged to Charlotte's mother. Emily then repudiates the contract while still executory. A court may properly grant Charlotte an order of specific performance against Emily. Specific performance is an attractive but *limited* remedy: it is only available for breach of contract to sell a unique item (real estate is always unique).

Restitution

As the word implies, restitution is a restoring to one party of what he gave to the other. Therefore, only to the extent that the injured party conferred a benefit on the other party may the injured party be awarded restitution.

If the claimant has given the other party a sum of money, there can be no dispute over the amount of the restitution interest. Tom gives Tim $100 to chop his tree into firewood. Tim repudiates. Tom's restitution interest is $100. But serious difficulties can arise

when the benefit conferred was performance. The courts have considerable discretion to award either the cost of hiring someone else to do the work that the injured party performed (generally, the market price of the service) or the value that was added to the property of the party in breach by virtue of the claimant's performance. Mellors, a gardener, agrees to construct ten fences around Lady Chatterley's flower gardens at the market price of $2,500. After erecting three, Mellors has performed services that would cost $750, market value. Assume that he has increased the value of the Lady's grounds by $800. If the contract is repudiated, there are two measures of Mellors's restitution interest: $800, the value by which the property was enhanced; or $750, the amount it would have cost Lady Chatterley to hire someone else to do the work. Which measure to use depends on who repudiated the contract and for what reason.

Tort vs. Contract Remedies

Frequently a contract breach may also amount to tortious conduct. A physician warrants her treatment as perfectly safe but performs the operation negligently, scarring the patient for life. The patient could sue for malpractice (tort) or for breach of warranty (contract). The choice involves at least four considerations:

1. *Statute of limitations.* Most statutes of limitations prescribe longer periods for contract than for tort actions. In California, (very) generally the statute of limitations for breach of contract cases is four years and for torts is three years.
2. *Allowable damages.* Punitive damages are more often permitted in tort actions, and certain kinds of injuries are compensable in tort but not in contract suits—for example, pain and suffering.
3. *Expert testimony.* In most cases, the use of experts would be the same in either tort or contract suits, but in certain contract cases, the expert witness could be dispensed with, as, for example, in a contract case charging that the physician abandoned the patient.
4. *Insurance coverage.* Most policies do not cover intentional torts, so a contract theory that avoids the element of willfulness would provide the plaintiff with a surer chance of recovering money damages.

Key Takeaways

The purpose of remedies in contract is, usually, to put the non-breaching party in the position he or she would have been in had there been no breach. The remedies are: compensatory damages (money paid to compensate the non-breaching party for the losses caused by the breach), which also include sub-categories of incidental and nominal damages; punitive damages (to punish the breaching party) are sometimes allowed where the breach is egregious and intentional.

Exercises

1. What are compensatory damages?
2. When is specific performance an appropriate remedy? Will it be used to require a person to perform a service (such as properly repair a leaky roof)?
3. When is restitution used?
4. How could a breach of contract also be a tort, and when is one cause of action chosen over the other?
5. What is the purpose of punitive damages?

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7.4: Summary and Exercises

Summary

In this chapter we have seen that two fundamental sources of contract law are the common law as developed in the state courts and as summarized in the *Restatement (Second) of Contracts*, and the Uniform Commercial Code for the sale of goods.

Sales law is a special type of contract law, governed by Article 2 of the UCC. Article 2 governs the sale of goods only, defined as things movable at the time of identification to the contract for sale. When the goods are "sold" incidental to a service, the courts do not agree on whether Article 2 applies. For two categories of goods, legislation specifically answers the question: foodstuffs served by a restaurant are goods; blood supplied for transfusions is not.

Types of contracts can be distinguished along these axes: (1) express and implied, including quasi-contracts implied by law; (2) bilateral and unilateral; (3) enforceable and unenforceable; and (4) completed (executed) and uncompleted (executory). To understand contract law, it is necessary to master these distinctions and their nuances.

In order to determine whether a valid, enforceable contract exists, the following questions must be answered: (1) Did the parties reach an agreement? (2) Was consideration present? (3) Was the agreement legal? (4) Did the parties have capacity to make a contract? (5) Was the agreement in the proper form?

Remedies available against someone who breaches a contract include damages, specific performance, and restitution. Frequently the party who is not in breach must choose between tort and contract remedies.

Exercises

1. On November 26, Joe wrote to Kate offering to purchase a farm that she owned. Upon receiving the letter on November 28, Kate immediately sent Joe a letter of acceptance. However, shortly after mailing the letter, Kate had second thoughts and called Joe to advise him that she was rejecting his offer. The call was made before Joe received the letter of acceptance. Has a contract been formed? Why?
2. On a busy day just before April 15, Albert Accountant received a call from a local car dealer. The dealer said, "Hi, Mr. Accountant. Now, while you have income from doing clients' taxes, I have an excellent offer for you. You can buy a new Buick Century automobile completely loaded for $36,000. Al, I know you're busy. If I don't hear from you by the end of the day, I'll assume you want the car." Albert, distracted, did not respond immediately, and the dealer hung up. Then followed an exhausting day of working with anxiety-ridden tax clients. Albert forgot about the conversation. Two days later a statement arrived from the dealer, with instructions on how Albert should pick up the car at the dealership. Is there a contract? Explain.
3. Bert purchased Ernie's car. Before selling the car, Ernie had stated to Bert, "This car runs well and is reliable. Last week I drove the car all the way from Seattle to San Francisco to visit my mother and back again to Seattle." In fact, Ernie was not telling the truth: he had driven the car to San Francisco to visit his paramour, not his mother. Upon discovery of the truth, may Bert avoid the contract? Why?
4. Langstraat was seventeen when he purchased a motorcycle. When applying for insurance, he signed a "Notice of Rejection," declining to purchase uninsured motorist coverage. He was involved in an accident with an uninsured motorist and sought to disaffirm his rejection of the uninsured motorist coverage on the basis of infancy. May he do so?
5. Richard promised to have Darlene's deck awning constructed by July 10. On June 20, Darlene called him and asked if he could get the job done by July 3, in time for Independence Day. Richard said he could, but he failed to do so, and Darlene had to rent two canopies at some expense. Darlene claims that because Richard breached his promise, he is liable for the cost of awning rental. Is she correct—was his promise binding? Why?
6. After taking a business law class at State U, Elke entered into a contract to sell her business law book to a classmate, Matthew, for $45. As part of the same contract, she agreed to prepare a will for Matthew's mother for an additional $110. Elke prepared the will and sent the book to Matthew, but he refused to pay her. Is she entitled to any payment? Explain.
7. Sara Hohe, a fifteen-year-old junior at Mission Bay High School in San Diego, was injured during a campus hypnotism show sponsored by the PTSA as a fund-raiser for the senior class. Hypnotism shows had been held annually since 1980, and Sara had seen the previous year's show. She was selected at random from a group of many volunteers. Her participation in the "Magic of the Mind Show" was conditioned on signing two release forms. Hohe's father signed a form entitled "Mission Bay High School PTSA Presents Dr. Karl Santo." Hohe and her father both signed a form titled "Karl Santo Hypnotist," releasing Santo and the

school district from all liability. During the course of the show, while apparently hypnotized, Hohe slid from her chair and also fell to the floor about six times and was injured. She, through her father, then sued the school district. The Hohes claimed the release was contrary to public policy; the trial court dismissed the suit on summary judgment. Was the release contrary to public policy? Decide.

8. Plaintiff Irma Kozlowski cohabited with Defendant Thaddeus Kozlowski for fifteen years without marriage. She repeatedly asked him specifically about her financial situation should he predecease her, and he assured her—she said—that he would arrange to provide for her for the rest of her life. She had provided the necessary household services and emotional support to permit him to successfully pursue his business career; she had performed housekeeping, cleaning, and shopping services and had run the household and raised the children, her own as well as his. When they separated and she was "literally forced out of the house," she was sixty-three years old and had no means or wherewithal for survival. When she sued, he raised the Statute of Frauds' one-year rule as a defense. Is the defense good?
9. Owner of an auto repair shop hires Contractor to remodel his shop but does not mention that two days after the scheduled completion date, Owner is to receive five small US Army personnel carrier trucks for service, with a three-week deadline to finish the job and turn the trucks over to the army. The contract between Owner and the army has a liquidated damages clause calling for $300 a day for every day trucks are not operable after the deadline. Contractor is five days late in finishing the remodel. Can Owner claim the $1,500 as damages against Contractor as a consequence of the latter's tardy completion of the contract? Explain.
10. Calvin, a promising young basketball and baseball player, signed a multiyear contract with a professional basketball team after graduating from college. After playing basketball for one year, he decided he would rather play baseball and breached his contract with the basketball team. What remedy could the team seek?

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CHAPTER OVERVIEW

8: Consumer Credit Transactions

Learning Objectives

After reading this chapter, you should understand the following:

- How consumers enter into credit transactions and what protections they are afforded when they do
- What rights consumers have after they have entered into a consumer transaction
- What debt collection practices third-party collectors may pursue

This chapter and the two that follow are devoted to debtor-creditor relations. In this chapter, we focus on the consumer credit transaction.

8.1: Introduction to Consumer Credit Transactions

8.2: Entering into a Credit Transaction

8.3: Consumer Protection Laws and Debt Collection Practices

8.4: Summary and Exercises

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8.1: Introduction to Consumer Credit Transactions

The amount of consumer debt, or household debt, owed by Americans to mortgage lenders, stores, automobile dealers, and other merchants who sell on credit is difficult to ascertain. According to Forbes, the average *credit card* debt (not including mortgages, auto loans, and student loans) per person in the United States in late 2025 was almost $7,000. The total household debt owed by Americans was $18.59 trillion, according to the Federal Reserve Board. That is really an incomprehensible number: suffice it to say, then, that the availability of credit is an important factor in the US economy, and not surprisingly, a number of statutes have been enacted over the years to protect consumers both before and after signing credit agreements.

The statutes tend to fall within three broad categories. First, several statutes are especially important when a consumer enters into a credit transaction. These include laws that regulate credit costs, the credit application, and the applicant's right to check a credit record. Second, after a consumer has contracted for credit, certain statutes give a consumer the right to cancel the contract and correct billing mistakes. Third, if the consumer fails to pay a debt, the creditor has several traditional debt collection remedies that today are tightly regulated by the government.

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8.2: Entering into a Credit Transaction

Learning Objectives

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

- Understand what statutes regulate the cost of credit, and the exceptions.
- Know how the cost of credit is expressed in the Truth in Lending Act.
- Recognize that there are laws prohibiting discrimination in credit granting.
- Understand how consumers' credit records are maintained and may be corrected.

The Cost of Credit

Lenders, whether banks or retailers, are not free to charge whatever they wish for credit. "Usury" is the illegal practice of lending money at unreasonably high rates of interest. of Usury laws establish a maximum rate of lawful interest. The penalties for violating usury laws vary from state to state. The heaviest penalties are loss of both principal and interest, or loss of a multiple of the interest the creditor charged. The courts often interpret these laws stringently, so that even if the impetus for a usurious loan comes from the borrower, the contract can be avoided, as demonstrated in *Matter of Dane's Estate* (Section 10.3).

Some states have eliminated interest rate limits altogether (that is, there are effectively no usury laws). In other states, usury law is riddled with exceptions, and indeed, in many cases, the exceptions have pretty much eaten up the general rule. Here are some common exceptions:

- Business loans. In many states, businesses may be charged any interest rate, although some states limit this exception to incorporated businesses.
- Mortgage loans. Mortgage loans are often subject to special usury laws. The allowable interest rates vary, depending on whether a first mortgage or a subordinate mortgage is given, or whether the loan is insured or provided by a federal agency, among other variables.
- Second mortgages and home equity loans by licensed consumer loan companies.
- Credit card and other retail installment debt. The interest rate for these is governed by the law of the state where the credit card company does business. (That's why the giant Citibank, otherwise headquartered in New York City, runs its credit card division out of South Dakota, which has no usury laws for credit cards.)
- Consumer leasing.
- "Small loans" such as payday loans and pawnshop loans.
- Lease-purchases on personal property. This is the lease-to-own concept.
- Certain financing of mobile homes that have become real property or where financing is insured by the federal government.
- Loans a person takes from her tax-qualified retirement plan.
- Certain loans from stockbrokers and dealers.
- Interest and penalties on delinquent property taxes.
- Deferred payment of purchase price (layaway loans).
- Statutory interest on judgments.

And there are others. Moreover, certain charges are not considered interest, such as fees to record documents in a public office and charges for services such as title examinations, deed preparation, credit reports, appraisals, and loan processing. But a creditor may not use these devices to cloak what is in fact a usurious bargain; it is not the form but the substance of the agreement that controls.

As suggested, part of the difficulty here is that governments at all levels have for a generation attempted to promote consumption to promote production; production is required to maintain politically acceptable levels of employment. If consumers can get what they want on credit, consumerism increases. Also, certainly, tight limits on interest rates cause creditors to deny credit to the less creditworthy, which may not be helpful to the lower classes. That's the rationale for the usury exceptions related to pawnshop and payday loans.

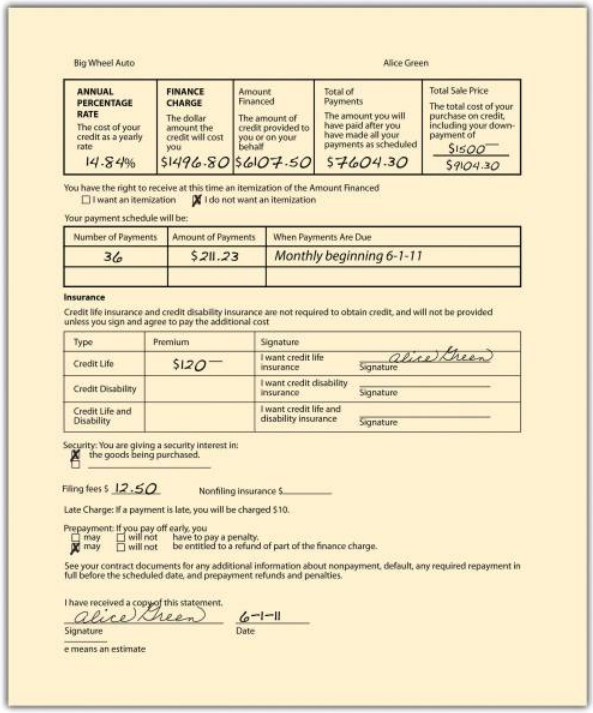
Disclosure of Credit Costs

Setting limits on what credit costs—as usury laws do—is one thing. Disclosing the cost of credit is another.

The Truth in Lending Act

Until 1969, lenders were generally free to disclose the cost of money loaned or credit extended in any way they saw fit—and they did. Financing and credit terms varied widely, and it was difficult and sometimes impossible to understand what the true cost was of a particular loan, much less to comparison shop. After years of failure, consumer interests finally persuaded Congress to pass a national law requiring disclosure of credit costs in 1968. Officially called the Consumer Credit Protection Act, Title I of the law is more popularly known as the Truth in Lending Act (TILA). The act only applies to *consumer* credit transactions, and it only protects natural-person debtors—it does not protect business organization debtors.

The act provides what its name implies: lenders must inform borrowers about significant terms of the credit transaction. The TILA does not establish maximum interest rates; these continue to be governed by state law. The two key terms that must be disclosed are the finance charge and the annual percentage rate. To see why, consider two simple loans of $1,000, each carrying interest of 10 percent, one payable at the end of twelve months and the other in twelve equal installments. Although the actual charge in each is the same—$100—the interest rate is not. Why? Because with the first loan you will have the use of the full $1,000 for the entire year; with the second, for much less than the year because you must begin repaying part of the principal within a month. In fact, with the second loan you will have use of only about half the money for the entire year, and so the actual rate of interest is closer to 15 percent. Things become more complex when interest is compounded and stated as a monthly figure, when different rates apply to various portions of the loan, and when processing charges and other fees are stated separately. The act regulates open-end credit (revolving credit, like charge cards) and closed-end credit (like a car loan—extending for a specific period), and—as amended later—it regulates consumer leases and credit card transactions, too.



Big Wheel Auto — Alice Green

ANNUAL PERCENTAGE RATE The cost of your credit as a yearly rate	FINANCE CHARGE The dollar amount the credit will cost you	Amount Financed The amount of credit provided to you or on your behalf	Total of Payments The amount you will have paid after you have made all your payments as scheduled	Total Sale Price The total cost of your purchase on credit, including your down-payment of $1500
14.84%	$1496.80	$6107.50	$7604.30	$9104.30

You have the right to receive at this time an itemization of the Amount Financed
☐ I want an itemization ☒ I do not want an itemization

Your payment schedule will be:

Number of Payments	Amount of Payments	When Payments Are Due
36	$211.23	Monthly beginning 6-1-11

Insurance

Credit life insurance and credit disability insurance are not required to obtain credit, and will not be provided unless you sign and agree to pay the additional cost

Type	Premium	Signature
Credit Life	$120	I want credit life insurance — Alice Green — Signature
Credit Disability		I want credit disability insurance — Signature
Credit Life and Disability		I want credit life and disability insurance — Signature

Security: You are giving a security interest in:
☒ the goods being purchased.
☐

Filing fees $ 12.50 Nonfiling insurance $

Late Charge: If a payment is late, you will be charged $10.

Prepayment: If you pay off early, you
☐ may ☐ will not have to pay a penalty.
☒ may ☐ will not be entitled to a refund of part of the finance charge.

See your contract documents for any additional information about nonpayment, default, any required repayment in full before the scheduled date, and prepayment refunds and penalties.

I have received a copy of this statement.
Alice Green — Signature
6-1-11 — Date

e means an estimate

Figure 10.1 Credit Disclosure Form

By requiring that the finance charge and the annual percentage rate be disclosed on a uniform basis, the TILA makes understanding and comparison of loans much easier. The finance charge is the total of all money paid for credit; it includes the interest paid over the life of the loan and all processing charges. The annual percentage rate is the true rate of interest for money or credit actually available to the borrower. The annual percentage rate must be calculated using the total finance charge (including all extra fees). See Figure 10.1 for an example of a disclosure form used by creditors.

Consumer Leasing Act of 1988

The Consumer Leasing Act (CLA) amends the TILA to provide similar full disclosure for consumers who lease automobiles or other goods from firms whose business it is to lease such goods, if the goods are valued at $25,000 or less and the lease is for four months or more. All material terms of the lease must be disclosed in writing.

Fair Credit and Charge Card Disclosure Act

In 1989, the Fair Credit and Charge Card Disclosure Act went into effect. This amends the TILA by requiring credit card issuers to disclose in a uniform manner the annual percentage rate, annual fees, grace period, and other information on credit card applications.

Credit Card Accountability, Responsibility, and Disclosure Act of 2009

The 1989 act did make it possible for consumers to know the costs associated with credit card use, but the card companies' behavior over 20 years convinced Congress that more regulation was required. In 2009, Congress passed and President Obama signed the Credit Card Accountability, Responsibility, and Disclosure Act of 2009 (the Credit Card Act). It is a further amendment of the TILA. Some of the salient parts of the act are as follows:

- Restricts all interest rate increases during the first year, with some exceptions. The purpose is to abolish "teaser" rates.
- Increases notice for rate increase on future purchases to 45 days.
- Preserves the ability to pay off on the old terms, with some exceptions.
- Limits fees and penalty interest and requires statements to clearly state the required due date and late payment penalty.
- Requires fair application of payments. Amounts in excess of the minimum payment must be applied to the highest interest rate (with some exceptions).
- Provides sensible due dates and time to pay.
- Protects young consumers. Before issuing a card to a person under the age of twenty-one, the card issuer must obtain an application that contains either the signature of a cosigner over the age of twenty-one or information indicating an independent means of repaying any credit extended.
- Restricts card issuers from providing tangible gifts to students on college campuses in exchange for filling out a credit card application.
- Requires colleges to publicly disclose any marketing contracts made with a card issuer.
- Requires enhanced disclosures.
- Requires issuers to disclose the period of time and the total interest it will take to pay off the card balance if only minimum monthly payments are made.
- Establishes gift card protections.Consumers Union, "Upcoming Credit Card Protections," www.creditcardreform.org/pdf/dodd-summary-509.pdf.

The Federal Reserve Board is to issue implementing rules.

Creditors who violate the TILA are subject to both criminal and civil sanctions. Of these, the most important are the civil remedies open to consumers. If a creditor fails to disclose the required information, a customer may sue to recover twice the finance charge, plus court costs and reasonable attorneys' fees, with some limitations. As to the Credit Card Act of 2009, the issuing companies were not happy with the reforms. Before the law went into effect, the companies—as one commentator put it—unleashed a "frenzy of retaliation," by repricing customer accounts, changing fixed rates to variable rates, lowering credit limits, and increasing fees. (Liz Pulliam Weston, "Credit Card Lenders Go on a Rampage," *MSN Money*, November 25, 2009.)

Getting Credit

Disclosure of credit costs is a good thing. After discovering how much credit will cost, a person might decide to go for it: get a loan or a credit card. The potential creditor, of course, should want to know if the applicant is a good risk; that requires a credit check. And somebody who knows another person's creditworthiness has what is usually considered confidential information, the possession of which is subject to abuse, and thus regulation.

Equal Credit Opportunity Act

Through the 1960s, banks and other lending and credit-granting institutions regularly discriminated against women. Banks told single women to find a cosigner for loans. Divorced women discovered that they could not open store charge accounts because they lacked a prior credit history, even though they had contributed to the family income on which previous accounts had been based. Married couples found that the wife's earnings were not counted when they sought credit; indeed, families planning to buy homes were occasionally even told that the bank would grant a mortgage if the wife would submit to a hysterectomy! In all these cases, the premise of the refusal to treat women equally was the unstated—and usually false—belief that women would quit work to have children or simply to stay home.

By the 1970s, as women became a major factor in the labor force, Congress reacted to the manifest unfairness of the discrimination by enacting (as part of the Consumer Credit Protection Act) the Equal Credit Opportunity Act (ECOA) of 1974. The act prohibits any creditor from discriminating "against any applicant on the basis of sex or marital status with respect to any aspect of a credit transaction." In 1976, Congress broadened the law to bar discrimination (1) on the basis of race, color, religion, national origin, and age; (2) because all or a part of an applicant's income is from a public assistance program; or (3) because an applicant has exercised his or her rights under the Consumer Credit Protection Act.

Under the ECOA, a creditor may not ask a credit applicant to state sex, race, national origin, or religion. And unless the applicant is seeking a joint loan or account or lives in a community-property state, the creditor may not ask for a statement of marital status or, if you have voluntarily disclosed that you are married, for information about your spouse, nor may one spouse be required to cosign if the other is deemed independently creditworthy. All questions concerning plans for children are improper. In assessing the creditworthiness of an applicant, the creditor must consider all sources of income, including regularly received alimony and child support payments. And if credit is refused, the creditor must, on demand, tell you the specific reasons for rejection. See *Rosa v. Park West Bank & Trust Co.* in Section 10.3 for a case involving the ECOA.

The Home Mortgage Disclosure Act, 1975, and the Community Reinvestment Act (CRA), 1977, get at another type of discrimination: redlining. This is the practice by a financial institution of refusing to grant home loans or home-improvement loans to people living in low-income neighborhoods. The act requires that financial institutions within its purview report annually by transmitting information from their Loan Application Registers to a federal agency. From these reports it is possible to determine what is happening to home prices in a particular area, whether investment in one neighborhood lags compared with that in others, if the racial or economic composition of borrowers changed over time, whether minorities or women had trouble accessing mortgage credit, in what kinds of neighborhoods subprime loans are concentrated, and what types of borrowers are most likely to receive subprime loans, among others. "Armed with hard facts, users of all types can better execute their work: Advocates can launch consumer education campaigns in neighborhoods being targeted by subprime lenders, planners can better tailor housing policy to market conditions, affordable housing developers can identify gentrifying neighborhoods, and activists can confront banks with poor lending records in low income communities. ("Kathryn L.S. Pettit and Audrey E. Droesch, "A Guide to Home Mortgage Disclosure Act Data," The Urban Institute, December 2008.) Under the CRA, federal regulatory agencies examine banking institutions for CRA compliance and take this information into consideration when approving applications for new bank branches or for mergers or acquisitions.

Fair Credit Reporting Act of 1970: Checking the Applicant's Credit Record

It is in the interests of all consumers that people who would be bad credit risks not get credit: if they do and they default (fail to pay their debts), the rest of us end up paying for their improvidence. Because credit is such a big business, a number of support industries have grown up around it. One of the most important is the credit-reporting industry, which addresses this issue of checking creditworthiness. Certain companies—credit bureaus—collect information about borrowers, holders of credit cards, store accounts, and installment purchasers. For a fee, this information—currently held on tens of millions of Americans—is sold to companies anxious to know whether applicants are creditworthy. If the information is inaccurate, it can lead to rejection of a credit application that should be approved, and it can wind up in other files where it can live to do more damage. In 1970, Congress enacted, as part of the Consumer Credit Protection Act, the Fair Credit Reporting Act (FCRA) to give consumers access to their credit files in order to correct errors.

Under this statute, an applicant denied credit has the right to be told the name and address of the credit bureau (called "consumer reporting agency" in the act) that prepared the report on which the denial was based. (The law covers reports used to screen

insurance and job applicants as well as to determine creditworthiness.) The agency must list the nature and substance of the information (except medical information) and its sources (unless they contributed to an investigative-type report). A credit report lists such information as name, address, employer, salary history, loans outstanding, and the like. An investigative-type report is one that results from personal interviews and may contain nonfinancial information, like drinking and other personal habits, character, or participation in dangerous sports. Since the investigators rely on talks with neighbors and coworkers, their reports are usually subjective and can often be misleading and inaccurate. Consumer reporting agencies are required to provide one free credit report annually, on request, to individual consumers.

The agency must furnish the consumer the information free if requested within thirty days of rejection and must also specify the name and address of anyone who has received the report within the preceding six months (two years if furnished for employment purposes).

If the information turns out to be inaccurate, the agency must correct its records; if investigative material cannot be verified, it must be removed from the file. Those to whom it was distributed must be notified of the changes. When the agency and the consumer disagree about the validity of the information, the consumer's version must be placed in the file and included in future distributions of the report. After seven years, any adverse information must be removed (ten years in the case of bankruptcy). A person is entitled to one free copy of his or her credit report from each of the three main national credit bureaus every twelve months. If a reporting agency fails to correct inaccurate information in a reasonable time, it is liable to the consumer for $1,000 plus attorneys' fees.

Under the FCRA, any person who obtains information from a credit agency under false pretenses is subject to criminal and civil penalties. The act is enforced by the Federal Trade Commission.

Key Takeaway

Credit is an important part of the US economy, and there are various laws regulating its availability and disclosure. Usury laws prohibit charging excessive interest rates, though the laws are riddled with exceptions. The disclosure of credit costs is regulated by the Truth in Lending Act of 1969, the Consumer Leasing Act of 1988, the Fair Credit and Charge Card Disclosure Act of 1989, and the Credit Card Accountability, Responsibility, and Disclosure Act of 2009 (these latter three are amendments to the TILA). Some states have adopted the Uniform Consumer Credit Code as well. Two major laws prohibit invidious discrimination in the granting of credit: the Equal Credit Opportunity Act of 1974 and the Home Mortgage Disclosure Act of 1975 (addressing the problem of redlining). The Fair Credit Reporting Act of 1970 governs the collection and use of consumer credit information held by credit bureaus.

Exercises

1. The penalty for usury varies from state to state. What are the two typical penalties?
2. What has the TILA done to the use of *interest* as a term to describe how much credit costs, and why?
3. What is redlining?
4. What does the Fair Credit Reporting Act do, in general?

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8.3: Consumer Protection Laws and Debt Collection Practices

Learning Objectives

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

- Understand that consumers have the right to cancel some purchases made on credit.
- Know how billing mistakes may be corrected.
- Recognize that professional debt collectors are governed by some laws restricting certain practices.

Cancellation Rights

Ordinarily, a contract is binding when signed. But consumer protection laws sometimes provide an escape valve. For example, a Federal Trade Commission (FTC) regulation gives consumers three days to cancel contracts made with door-to-door salespersons. Under this cooling-off provision, the cancellation is effective if made by midnight of the third business day after the date of the purchase agreement. The salesperson must notify consumers of this right and supply them with two copies of a cancellation form, and the sales agreement must contain a statement explaining the right. The purchaser cancels by returning one copy of the cancellation form to the seller, who is obligated either to pick up the goods or to pay shipping costs. The three-day cancellation privilege applies only to sales of twenty-five dollars or more made either in the home or away from the seller's place of business; it does not apply to sales made by mail or telephone, to emergency repairs and certain other home repairs, or to real estate, insurance, or securities sales.

The Truth in Lending Act (TILA) protects consumers in a similar way. For certain big-ticket purchases (such as installations made in the course of major home improvements), sellers sometimes require a mortgage (which is subordinate to any preexisting mortgages) on the home. The law gives such customers three days to rescind the contract. Many states have laws similar to the FTC's three-day cooling-off period, and these may apply to transactions not covered by the federal rule (e.g., to purchases of less than twenty-five dollars and even to certain contracts made at the seller's place of business).

Correcting Billing Mistakes

Billing Mistakes

In 1975, Congress enacted the Fair Credit Billing Act as an amendment to the Consumer Credit Protection Act. It was intended to put to an end the phenomenon, by then a standard part of any comedian's repertoire, of the many ways a computer could insist that you pay a bill, despite errors and despite letters you might have written to complain. The act, which applies only to open-end credit and not to installment sales, sets out a procedure that creditors and customers must follow to rectify claimed errors. The customer has sixty days to notify the creditor of the nature of the error and the amount. Errors can include charges not incurred or those billed with the wrong description, charges for goods never delivered, accounting or arithmetic errors, failure to credit payments or returns, and even charges for which you simply request additional information, including proof of sale. During the time the creditor is replying, you need not pay the questioned item or any finance charge on the disputed amount.

The creditor has thirty days to respond and ninety days to correct your account or explain why your belief that an error has been committed is incorrect. If you do turn out to be wrong, the creditor is entitled to all back finance charges and to prompt payment of the disputed amount. If you persist in disagreeing and notify the creditor within ten days, it is obligated to tell all credit bureaus to whom it sends notices of delinquency that the bill continues to be disputed and to tell you to whom such reports have been sent; when the dispute has been settled, the creditor must notify the credit bureaus of this fact. Failure of the creditor to follow the rules, an explanation of which must be provided to each customer every six months and when a dispute arises, bars it from collecting the first fifty dollars in dispute, plus finance charges, even if the creditor turns out to be correct.

Disputes about the Quality of Goods or Services Purchased

While disputes over the quality of goods are not "billing errors," the act does apply to unsatisfactory goods or services purchased by credit card (except for store credit cards); the customer may assert against the credit card company any claims or defenses he or she may have against the seller. This means that under certain circumstances, the customer may withhold payments without incurring additional finance charges. However, this right is subject to three limitations: (1) the value of the goods or services

charged must be in excess of fifty dollars, (2) the goods or services must have been purchased either in the home state or within one hundred miles of the customer's current mailing address, and (3) the consumer must make a good-faith effort to resolve the dispute before refusing to pay. If the consumer does refuse to pay, the credit card company would acquiesce: it would credit her account for the disputed amount, pass the loss down to the merchant's bank, and that bank would debit the merchant's account. The merchant would then have to deal with the consumer directly.

Debt Collection Practices

Banks, financial institutions, and retailers have different incentives for extending credit—for some, a loan is simply a means of making money, and for others, it is an inducement to buyers. But in either case, credit is a risk because the consumer may default; the creditor needs a means of collecting when the customer fails to pay. Open-end credit is usually given without collateral. The creditor can, of course, sue, but if the consumer has no assets, collection can be troublesome. Historically, three different means of recovering the debt have evolved: garnishment, wage assignment, and confession of judgment.

Garnishment

Garnishment is a legal process by which a creditor obtains a court order directing the debtor's employer (or any party who owes money to the debtor) to pay directly to the creditor a certain portion of the employee's wages until the debt is paid. Until 1970, garnishment was regulated by state law, and its effects could be devastating—in some cases, even leading to suicide. In 1970, Title III of the Consumer Credit Protection Act asserted federal control over garnishment proceedings for the first time. The federal wage-garnishment law limits the amount of employee earnings that may be withheld in any one pay date to the lesser of 25 percent of disposable (after-tax) earnings or the amount by which disposable weekly earnings exceed thirty times the highest current federal minimum wage. The federal law covers everyone who receives personal earnings, including wages, salaries, commissions, bonuses, and retirement income (though not tips), but it allows courts to garnish above the federal maximum in cases involving support payments (e.g., alimony), in personal bankruptcy cases, and in cases where the debt owed is for state or federal tax.

The federal wage-garnishment law also prohibits an employer from firing any worker solely because the worker's pay has been garnished for one debt (multiple garnishments may be grounds for discharge). The penalty for violating this provision is a $1,000 fine, one-year imprisonment, or both. But the law does not say that an employee fired for having one debt garnished may sue the employer for damages. In a 1980 case, the Fifth Circuit Court of Appeals denied an employee the right to sue, holding that the statute places enforcement exclusively in the hands of the federal secretary of labor. (*Smith v. Cotton Brothers Baking Co., Inc*., 609 F.2d 738 (5th Cir. 1980).)

The l970 federal statute is not the only limitation on the garnishment process. Note that the states can also still regulate garnishment so long as the state regulation is not in conflict with federal law: North Carolina, Pennsylvania, South Carolina, and Texas prohibit most garnishments, unless it is the government doing the garnishment. And there is an important constitutional limitation as well. Many states once permitted a creditor to garnish the employee's wage even before the case came to court: a simple form from the clerk of the court was enough to freeze a debtor's wages, often before the debtor knew a suit had been brought. In 1969, the US Supreme Court held that this prejudgment garnishment procedure was unconstitutional. (*Sniadach v. Family Finance Corp*., 395 U.S. 337 (1969).)

Wage Assignment

A wage assignment is an agreement by an employee that a creditor may take future wages as security for a loan or to pay an existing debt. With a wage assignment, the creditor can collect directly from the employer. However, in some states, wage assignments are unlawful, and an employer need not honor the agreement (indeed, it would be liable to the employee if it did). Other states regulate wage assignments in various ways—for example, by requiring that the assignment be a separate instrument, not part of the loan agreement, and by specifying that no wage assignment is valid beyond a certain period of time (two or three years).

Confession of Judgment

Because suing is at best nettlesome, many creditors have developed forms that allow them to sidestep the courthouse when debtors have defaulted. As part of the original credit agreement, the consumer or borrower waives his right to defend himself in court by signing a confession of judgment. This written instrument recites the debtor's agreement that a court order be automatically entered

against him in the event of default. The creditor's lawyer simply takes the confession of judgment to the clerk of the court, who enters it in the judgment book of the court without ever consulting a judge. Entry of the judgment entitles the creditor to attach the debtor's assets to satisfy the debt. Like prejudgment garnishment, a confession of judgment gives the consumer no right to be heard, and it has been banned by statute or court decisions in many states.

Fair Debt Collection Practices Act of 1977

Many stores, hospitals, and other organizations attempt on their own to collect unpaid bills, but thousands of merchants, professionals, and small businesses rely on collection agencies to recover accounts receivable. The debt collection business employed some 216,000 people in 2007 and collected over $40 billion in debt.PricewaterhouseCoopers LLP, *Value of Third-Party Debt Collection to the U.S. Economy in 2007: Survey And Analysis*, June 2008, www.acainternational.org/files.aspx?p=/images/12546/pwc2007-final.pdf. For decades, some of these collectors used harassing tactics: posing as government agents or attorneys, calling at the debtor's workplace, threatening physical harm or loss of property or imprisonment, using abusive language, publishing a deadbeats list, misrepresenting the size of the debt, and telling friends and neighbors about the debt. To provide a remedy for these abuses, Congress enacted, as part of the Consumer Credit Protection Act, the Fair Debt Collection Practices Act (FDCPA) in 1977.

This law regulates the manner by which third-party collection agencies conduct their business. It covers collection of all personal, family, and household debts by collection agencies. It does not deal with collection by creditors themselves; the consumer's remedy for abusive debt collection by the creditor is in tort law.

Under the FDCPA, the third-party collector may contact the debtor only during reasonable hours and not at work if the debtor's employer prohibits it. The debtor may write the collector to cease contact, in which case the agency is prohibited from further contact (except to confirm that there will be no further contact). A written denial that money is owed stops the bill collector for thirty days, and he can resume again only after the debtor is sent proof of the debt. Collectors may no longer file suit in remote places, hoping for default judgments; any suit must be filed in a court where the debtor lives or where the underlying contract was signed. The use of harassing and abusive tactics, including false and misleading representations to the debtor and others (e.g., claiming that the collector is an attorney or that the debtor is about to be sued when that is not true), is prohibited. Unless the debtor has given the creditor her cell phone number, calls to cell phones (but not to landlines) are not allowed. In any mailings sent to the debtor, the return address cannot indicate that it is from a debt collection agency (so as to avoid embarrassment from a conspicuous name on the envelope that might be read by third parties).

Communication with third parties about the debt is not allowed, except when the collector may need to talk to others to trace the debtor's whereabouts (though the collector may not tell them that the inquiry concerns a debt) or when the collector contacts a debtor's attorney, if the debtor has an attorney. The federal statute gives debtors the right to sue the collector for damages for violating the statute and for causing such injuries as job loss or harm to reputation.

Key Takeaway

Several laws regulate practices after consumer credit transactions. The FTC provides consumers with a three-day cooling-off period for some in-home sales, during which time the consumer-purchaser may cancel the sale. The TILA and some state laws also have some cancellation provisions. Billing errors are addressed by the Fair Credit Billing Act, which gives consumers certain rights. Debt collection practices such as garnishment, wage assignments, and confessions of judgment are regulated (and in some states prohibited) by federal and state law. Debt collection practices for third-party debt collectors are constrained by the Fair Debt Collection Practices Act.

Exercises

1. Under what circumstances may a consumer have three days to avoid a contract?
2. How does the Fair Credit Billing Act resolve the problem that occurs when a consumer disputes a bill and "argues" with a computer about it?
3. What is the constitutional problem with garnishment as it was often practiced before 1969?
4. If Joe of Joe's Garage wants to collect on his own the debts he is owed, he is not constrained by the FDCPA. What limits are there on his debt collection practices?

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8.4: Summary and Exercises

Summary

Consumers who are granted credit have long received protection through usury laws (laws that establish a maximum interest rate). The rise in consumer debt in recent years has been matched by an increase in federal regulation of consumer credit transactions. The Truth in Lending Act requires disclosure of credit terms; the Equal Credit Opportunity Act prohibits certain types of discrimination in the granting of credit; the Fair Credit Reporting Act gives consumers access to their credit dossiers and prohibits unapproved use of credit-rating information. After entering into a credit transaction, a consumer has certain cancellation rights and may use a procedure prescribed by the Fair Credit Billing Act to correct billing errors. Traditional debt collection practices—garnishment, wage assignments, and confession of judgment clauses—are now subject to federal regulation, as are the practices of collection agencies under the Fair Debt Collection Practices Act.

Exercises

1. Carlene Consumer entered into an agreement with Rent to Buy, Inc., to rent a computer for $20 per week. The agreement also provided that if Carlene chose to rent the computer for fifty consecutive weeks, she would own it. She then asserted that the agreement was not a lease but a sale on credit subject to the Truth in Lending Act, and that Rent to Buy, Inc., violated the act by failing to state the annual percentage rate. Is Carlene correct?
2. Carlos, a resident of Chicago, was on a road trip to California when he heard a noise under the hood of his car. He took the car to a mechanic for repair. The mechanic overhauled the power steering unit and billed Carlos $600, which he charged on his credit card. Later that day—Carlos having driven about fifty miles—the car made the same noise, and Carlos took it to another mechanic, who diagnosed the problem as a loose exhaust pipe connection at the manifold. Carlos was billed $300 for this repair, with which he was satisfied. Carlos returned to Chicago and examined his credit card statement. What rights has he as to the $600 charge on his card?
3. Ken was the owner of Scrimshaw, a company that manufactured and sold carvings made on fossilized ivory. He applied for a loan from Bank. Bank found him creditworthy, but seeking additional security for repayment, it required his wife, Linda, to sign a guaranty as well. During a subsequent recession, demand for scrimshaw fell, and Ken's business went under. Bank filed suit against both Ken and Linda. What defense has Linda?
4. The FCRA requires that credit-reporting agencies "follow reasonable procedures to assure maximum possible accuracy of the information." In October of 1989, Renie Guimond became aware of, and notified the credit bureau Trans Union about, inaccuracies in her credit report: that she was married (and it listed a Social Security number for this nonexistent spouse), that she was also known as Ruth Guimond, and that she had a Saks Fifth Avenue credit card. About a month later, Trans Union responded to Guimond's letter, stating that the erroneous information had been removed. But in March of 1990, Trans Union again published the erroneous information it purportedly had removed. Guimond then requested the source of the erroneous information, to which Trans Union responded that it could not disclose the identity of the source because it did not know its source. The disputed information was eventually removed from Guimond's file in October 1990. When Guimond sued, Trans Union defended that she had no claim because no credit was denied to her as a result of the inaccuracies in her credit file. The lower court dismissed her case; she appealed. To what damages, if any, is Guimond entitled?
5. The immediate payment of the full amount, or a personal visit to this office, will spare you this embarrassment.

   The top of the letter notes the creditor's name and the amount of the alleged debt. The letter was signed by a "collection agent." The envelope containing that letter presented a return address that included Defendant's full name: "Collection Accounts Terminal, Inc." What violations of the Fair Debt Collection Practices Act are here presented?

6. Eric and Sharaveen Rush filed a claim alleging violations of the Fair Credit Reporting Act arising out of an allegedly erroneous credit report prepared by a credit bureau from information, in part, from Macy's, the department store. The error causes the Rushes to be denied credit. Macy's filed a motion to dismiss. Is Macy's liable? Discuss.

SELF CHECK QUESTIONS

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CHAPTER OVERVIEW

9: Mortgages and Nonconsensual Liens

Learning Objectives

After reading this chapter, you should understand the following:

- The basic concepts of mortgages
- How the mortgage is created
- Priorities with mortgages as security devices
- Termination of the mortgage
- Other methods of using real estate as security
- Nonconsensual liens

9.1: Uses, History, and Creation of Mortgages

9.2: Priority, Termination of the Mortgage, and Other Methods of Using Real Estate as Security

9.3: Nonconsensual Liens

9.4: Summary and Exercises

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9.1: Uses, History, and Creation of Mortgages

Learning Objectives

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

- Understand the terminology used in mortgage transactions, and how mortgages are used as security devices.
- Know a bit about the history of mortgages.
- Understand how the mortgage is created.

Loans and extensions of credit are often backed up--secured--by a legal claim or right. We call these legal rights to collect property to secure the repayment of a debt a "security arrangement." Often, these security arrangements take the form of a "lien." A lien is a legal right to property to secure the repayment of debt. For instance, in exchange for lending money to a consumer to purchase a car, a car finance company often will require the consumer to agree to the company having a lien on the car to ensure the consumer repays the loan. If the consumer fails to repay the loan under its terms, the company can execute its lien (that is, enforce its rights under the lien) by repossessing the car. This chapter discusses a similar concept: the mortgage. We also discuss briefly various forms of nonconsensual liens (see Figure 9.1.1).

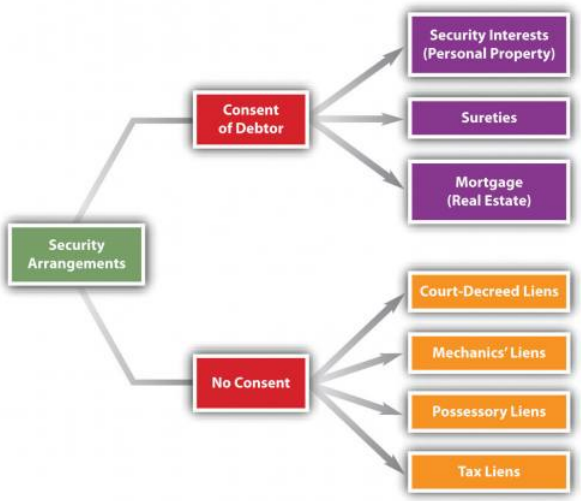


Figure 9.1.1: Security Arrangements

Definitions

A **mortgage** is a means of securing a debt with real estate. A long time ago, the mortgage was considered an actual transfer of title, to become void if the debt was paid off. The modern view, held in most states, is that the mortgage is but a lien, giving the holder, in the event of default, the right to sell the property and repay the debt from the proceeds. The person giving the mortgage is the mortgagor, or borrower. In the typical home purchase, that's the buyer. The buyer needs to borrow to finance the purchase; in exchange for the money with which to pay the seller, the buyer "takes out a mortgage" with, say, a bank. The lender is the mortgagee, the person or institution holding the mortgage, with the right to foreclose on the property if the debt is not timely paid. Although the law of real estate mortgages is different from the set of rules in Article 9 of the **Uniform Commercial Code (UCC)** that we examined in Chapter 11, the circumstances are the same, except that the security is real estate rather than personal property (secured transactions) or the promise of another (suretyship).

The Uses of Mortgages

Most frequently, we think of a mortgage as a device to fund a real estate purchase: for a homeowner to buy her house, or for a commercial entity to buy real estate (e.g., an office building), or for a person to purchase farmland. But the value in real estate can be mortgaged for almost any purpose (a home equity loan): a person can take out a mortgage on land to fund a vacation. Indeed, during the period leading up to the recession in 2007–08, a lot of people borrowed money on their houses to buy things: boats, new

cars, furniture, and so on. Unfortunately, it turned out that some of the real estate used as collateral was overvalued: when the economy weakened and people lost income or their jobs, they couldn't make the mortgage payments. And, to make things worse, the value of the real estate sometimes sank too, so that the debtors owed more on the property than it was worth (that's called being underwater). They couldn't sell without taking a loss, and they couldn't make the payments. Some debtors just walked away, leaving the banks with a large number of houses, commercial buildings, and even shopping centers on their hands.

Short History of Mortgage Law

The mortgage has ancient roots, but the form we know evolved from the English land law in the Middle Ages. Understanding that law helps to understand modern mortgage law. In the fourteenth century, the mortgage was a deed that actually transferred title to the mortgagee. If desired, the mortgagee could move into the house, occupy the property, or rent it out. But because the mortgage obligated him to apply to the mortgage debt whatever rents he collected, he seldom ousted the mortgagor. Moreover, the mortgage set a specific date (the "law day") on which the debt was to be repaid. If the mortgagor did so, the mortgage became void and the mortgagor was entitled to recover the property. If the mortgagor failed to pay the debt, the property automatically vested in the mortgagee. No further proceedings were necessary.

This law was severe. A day's delay in paying the debt, for any reason, forfeited the land, and the courts strictly enforced the mortgage. The only possible relief was a petition to the king, who over time referred these and other kinds of petitions to the courts of equity. At first fitfully, and then as a matter of course (by the seventeenth century), the equity courts would order the mortgagee to return the land when the mortgagor stood ready to pay the debt plus interest. Thus a new right developed: the *equitable right of redemption*, known for short as the **equity of redemption**. In time, the courts held that this equity of redemption was a form of property right; it could be sold and inherited. This was a powerful right: no matter how many years later, the mortgagor could always recover his land by proffering a sum of money.

Understandably, mortgagees did not warm to this interpretation of the law, because their property rights were rendered insecure. They tried to defeat the equity of redemption by having mortgagors waive and surrender it to the mortgagees, but the courts voided waiver clauses as a violation of public policy. Hence a mortgage, once a transfer of title, became a security for debt. A mortgage as such can never be converted into a deed of title.

The law did not rest there. Mortgagees won a measure of relief in the development of the **foreclosure**. On default, the mortgagee would seek a court order giving the mortgagor a fixed time—perhaps six months or a year—within which to pay off the debt; under the court decree, failure meant that the mortgagor was forever foreclosed from asserting his right of redemption. This strict foreclosure gave the mortgagee outright title at the end of the time period.

In the United States today, most jurisdictions follow a somewhat different approach: the mortgagee forecloses by forcing a public sale at auction. Proceeds up to the amount of the debt are the mortgagee's to keep; surplus is paid over to the mortgagor. Foreclosure by sale is the usual procedure in the United States. At bottom, its theory is that a mortgage is a lien on land. (Foreclosure issues are further discussed in Section 12.2.)

Under statutes enacted in many states, the mortgagor has one last chance to recover his property, even after foreclosure. This statutory right of redemption extends the period to repay, often by one year.

Creation of the Mortgage

Statutory Regulation

The decision whether to lend money and take a mortgage is affected by several federal and state regulations.

Consumer Credit Statutes Apply

Statutes dealing with consumer credit transactions (as discussed in Chapter 8) have a bearing on the mortgage, including state usury statutes, and the federal Truth in Lending Act and Equal Credit Opportunity Act.

Real Estate Settlement Procedures Act

Other federal statutes are directed more specifically at mortgage lending. One, enacted in 1974, is the Real Estate Settlement Procedures Act (RESPA), aimed at abuses in the settlement process—the process of obtaining the mortgage and purchasing a residence. The act covers all federally related first mortgage loans secured by residential properties for one to four families. It

requires the lender to disclose information about settlement costs in advance of the closing day: it prohibits the lender from "springing" unexpected or hidden costs onto the borrower. The RESPA is a US Department of Housing and Urban Development (HUD) consumer protection statute designed to help home buyers be better shoppers in the home-buying process, and it is enforced by HUD. It also outlaws what had been a common practice of giving and accepting kickbacks and referral fees. The act prohibits lenders from requiring mortgagors to use a particular company to obtain insurance, and it limits add-on fees the lender can demand to cover future insurance and tax charges.

Redlining. Several statutes are directed to the practice of redlining—the refusal of lenders to make loans on property in low-income neighborhoods or impose stricter mortgage terms when they do make loans there. (The term derives from the supposition that lenders draw red lines on maps around ostensibly marginal neighborhoods.) The most important of these is the Community Reinvestment Act (CRA) of 1977.12 United States Code, Section 2901. The act requires the appropriate federal financial supervisory agencies to encourage regulated financial institutions to meet the credit needs of the local communities in which they are chartered, consistent with safe and sound operation. To enforce the statute, federal regulatory agencies examine banking institutions for CRA compliance and take this information into consideration when approving applications for new bank branches or for mergers or acquisitions. The information is compiled under the authority of the Home Mortgage Disclosure Act of 1975, which requires financial institutions within its purview to report annually by transmitting information from their loan application registers to a federal agency.

The Note and the Mortgage Documents

The note and the mortgage documents are the contracts that set up the deal: the mortgagor gets credit, and the mortgagee gets the right to repossess the property in case of default.

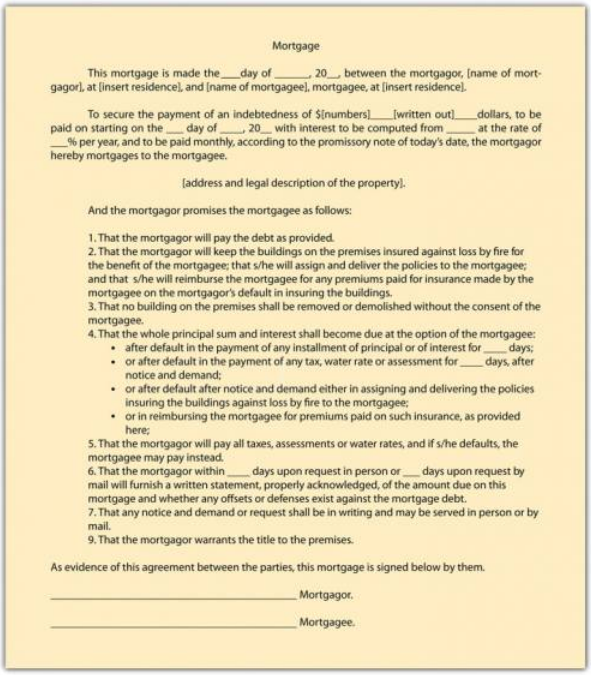
The Note

If the lender decides to grant a mortgage, the mortgagor signs two critical documents at the closing: the note and the mortgage. It is enough here to recall that in a note (really a type of IOU), the mortgagor promises to pay a specified principal sum, plus interest, by a certain date or dates. The note is the underlying obligation for which the mortgage serves as security. Without the note, the mortgagee would have an empty document, since the mortgage would secure nothing. Without a mortgage, a note is still quite valid, evidencing the debtor's personal obligation.

One particular provision that usually appears in both mortgages and the underlying notes is the acceleration clause. This provides that if a debtor should default on any particular payment, the entire principal and interest will become due immediately at the lender's option. Why an acceleration clause? Without it, the lender would be powerless to foreclose the entire mortgage when the mortgagor defaulted but would have to wait until the expiration of the note's term. Although the acceleration clause is routine, it will not be enforced unless the mortgagee acts in an equitable and fair manner. The problem arises where the mortgagor's default was the result of some unconscionable conduct of the mortgagee, such as representing to the mortgagee that she might take a sixty-day "holiday" from having to make payments. In *Paul H. Cherry v. Chase Manhattan Mortgage Group* (Section 12.4), the equitable powers of the court were invoked to prevent acceleration.

The Mortgage

Under the statute of frauds, the mortgage itself must be evidenced by some writing to be enforceable. The mortgagor will usually make certain promises and warranties to the mortgagee and state the amount and terms of the debt and the mortgagor's duties concerning taxes, insurance, and repairs. A sample mortgage form is presented in Figure 12.2.



Mortgage

This mortgage is made the ___day of _____, 20__, between the mortgagor, [name of mortgagor], at [insert residence], and [name of mortgagee], mortgagee, at [insert residence].

To secure the payment of an indebtedness of $[numbers]____[written out]____dollars, to be paid on starting on the ___ day of ____, 20__ with interest to be computed from _____ at the rate of ___% per year, and to be paid monthly, according to the promissory note of today's date, the mortgagor hereby mortgages to the mortgagee.

[address and legal description of the property].

And the mortgagor promises the mortgagee as follows:

1. That the mortgagor will pay the debt as provided.
2. That the mortgagor will keep the buildings on the premises insured against loss by fire for the benefit of the mortgagee; that s/he will assign and deliver the policies to the mortgagee; and that s/he will reimburse the mortgagee for any premiums paid for insurance made by the mortgagee on the mortgagor's default in insuring the buildings.
3. That no building on the premises shall be removed or demolished without the consent of the mortgagee.
4. That the whole principal sum and interest shall become due at the option of the mortgagee:
   - after default in the payment of any installment of principal or of interest for ____ days;
   - or after default in the payment of any tax, water rate or assessment for ____ days, after notice and demand;
   - or after default after notice and demand either in assigning and delivering the policies insuring the buildings against loss by fire to the mortgagee;
   - or in reimbursing the mortgagee for premiums paid on such insurance, as provided here;
5. That the mortgagor will pay all taxes, assessments or water rates, and if s/he defaults, the mortgagee may pay instead.
6. That the mortgagor within ____ days upon request in person or ___ days upon request by mail will furnish a written statement, properly acknowledged, of the amount due on this mortgage and whether any offsets or defenses exist against the mortgage debt.
7. That any notice and demand or request shall be in writing and may be served in person or by mail.
9. That the mortgagor warrants the title to the premises.

As evidence of this agreement between the parties, this mortgage is signed below by them.

_____ Mortgagor.

_____ Mortgagee.

Figure 12.2 Sample Mortgage Form

Key Takeaway

As a mechanism of security, a mortgage is a promise by the debtor (mortgagor) to repay the creditor (mortgagee) for the amount borrowed or credit extended, with real estate put up as security. If the mortgagor doesn't pay as promised, the mortgagee may repossess the real estate. Mortgage law has ancient roots and brings with it various permutations on the theme that even if the mortgagor defaults, she may nevertheless have the right to get the property back or at least be reimbursed for any value above that necessary to pay the debt and the expenses of foreclosure. Mortgage law is regulated by state and federal statute.

Exercises

1. What role did the right of redemption play in courts of equity changing the substance of a mortgage from an actual transfer of title to the mortgagee to a mere lien on the property?
2. What abuses did the federal RESPA address?
3. What are the two documents most commonly associated with mortgage transactions?

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9.2: Priority, Termination of the Mortgage, and Other Methods of Using Real Estate as Security

Learning Objectives

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

- Understand why it is important that the mortgagee (creditor) record her interest in the debtor's real estate.
- Know the basic rule of priority—who gets an interest in the property first in case of default—and the exceptions to the rule.
- Recognize the three ways mortgages can be terminated: payment, assumption, and foreclosure.
- Be familiar with other methods (besides mortgages) by which real property can be used as security for a creditor.

Priorities in Real Property Security

You may recall from Chapter 11 how important it is for a creditor to perfect its secured interest in the goods put up as collateral. Absent perfection, the creditor stands a chance of losing out to another creditor who took its interest in the goods subsequent to the first creditor. The same problem is presented in real property security: the mortgagee wants to make sure it has first claim on the property in case the mortgagor (debtor) defaults.

The General Rule of Priorities

The general rule of priority is the same for real property security as for personal property security: the first in time to give notice of the secured interest is first in right. For real property, the notice is by recording the mortgage. Recording is the act of giving public notice of changes in interests in real estate. Recording was created by statute; it did not exist at common law. The typical recording statute calls for a transfer of title or mortgage to be placed in a particular county office, usually the auditor, recorder, or register of deeds. For Santa Ana real estate, the Orange County Clerk-Recorder's office is the place for recording real estate instruments.

A mortgage is valid between the parties whether or not it is recorded, but a mortgagee might lose to a third party—another mortgagee or a good-faith purchaser of the property—unless the mortgage is recorded.

Termination of the Mortgage

The mortgagor's liability can terminate in three ways: payment, assumption (with a novation), or foreclosure.

Payment

Unless they live in the home for twenty-five or thirty years, the mortgagors usually pay off the mortgage when the property is sold. Occasionally, mortgages are paid off in order to refinance. If the mortgage was taken out at a time of high interest rates and rates later drop, the homeowner might want to obtain a new mortgage at the lower rates. In many mortgages, however, this entails extra closing costs and penalties for prepaying the original mortgage. Whatever the reason, when a mortgage is paid off, the discharge should be recorded. This is accomplished by giving the mortgagor a copy of, and filing a copy of, a Satisfaction of Mortgage document.

Assumption

The property can be sold without paying off the mortgage if the mortgage is assumed by the new buyer, who agrees to pay the seller's (the original mortgagor's) debt. This is a novation *if*, in approving the assumption, the bank releases the old mortgagor and substitutes the buyer as the new debtor.

The buyer need not assume the mortgage. If the buyer purchases the property without agreeing to be personally liable, this is a sale "subject to" the mortgage (see Figure 12.3 Sales versus Assumption"). In the event of the seller's subsequent default, the bank can foreclose the mortgage and sell the property that the buyer has purchased, but the buyer is not liable for any deficiency.

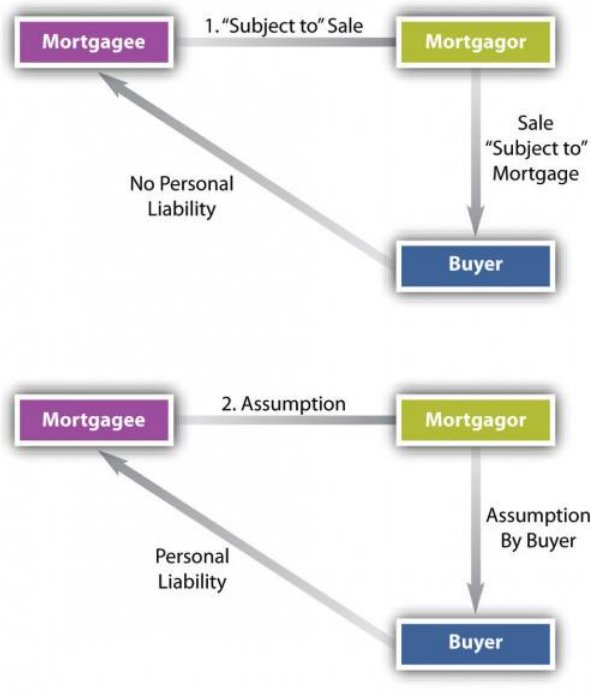


Figure 12.3 "Subject to" Sales versus Assumption

What if mortgage rates are high? Can buyers assume an existing low-rate mortgage from the seller rather than be forced to obtain a new mortgage at substantially higher rates? Banks, of course, would prefer not to allow that when interest rates are rising, so they often include in the mortgage a due-on-sale clause, by which the entire principal and interest become due when the property is sold, thus forcing the purchaser to get financing at the higher rates. The clause is a device for preventing subsequent purchasers from assuming loans with lower-than-market interest rates. Although many state courts at one time refused to enforce the due-on-sale clause, Congress reversed this trend when it enacted the Garn–St. Germain Depository Institutions Act in 1982.12 United States Code, Section 1701-j. The act preempts state laws and upholds the validity of due-on-sale clauses. When interest rates are low, banks have no interest in enforcing such clauses, and there are ways to work around the due-on-sale clause.

Foreclosure

The third method of terminating the mortgage is by foreclosure when a mortgagor defaults. Even after default, the mortgagor has the right to exercise his equity of redemption—that is, to redeem the property by paying the principal and interest in full. If he does not, the mortgagee may foreclose the equity of redemption. Although strict foreclosure is used occasionally, in most cases the mortgagee forecloses by one of two types of sale (see Figure 12.4).

The first type is judicial sale. The mortgagee seeks a court order authorizing the sale to be conducted by a public official, usually the sheriff. The mortgagor is entitled to be notified of the proceeding and to a hearing. The second type of sale is that conducted under a clause called a power of sale, which many lenders insist be contained in the mortgage. This clause permits the mortgagee to sell the property at public auction without first going to court—although by custom or law, the sale must be advertised, and typically a sheriff or other public official conducts the public sale or auction.

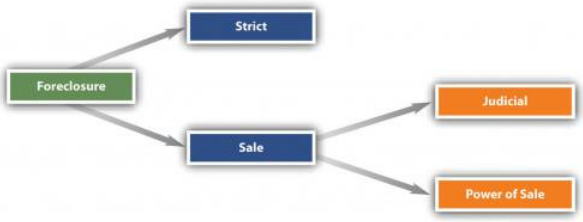


Figure 12.4 Foreclosure

Once the property has been sold, it is deeded to the new purchaser. In about half the states, the mortgagor still has the right to redeem the property by paying up within six months or a year—the statutory redemption period. Thereafter, the mortgagor has no further right to redeem. If the sale proceeds exceed the debt, the mortgagor is entitled to the excess unless he has given second and third mortgages, in which case the junior mortgagees are entitled to recover their claims before the mortgagor. If the proceeds are less than the debt, the mortgagee is entitled to recover the deficiency from the mortgagor. However, some states have statutorily abolished deficiency judgments.

Other Methods of Using Real Estate as Security

Besides the mortgage, there are other ways to use real estate as security. Here we take up two: the deed of trust and the installment or land contract.

Deed of Trust

The deed of trust is a device for securing a debt with real property; unlike the mortgage, it requires three parties: the borrower, the trustee, and the lender. Otherwise, it is at base identical to a mortgage. The borrower conveys the land to a third party, the trustee, to hold in trust for the lender until the borrower pays the debt. (The trustee's interest is really a kind of legal fiction: that person is expected to have no interest in the property.) The primary benefit to the deed of trust is that it simplifies the foreclosure process by containing a provision empowering the trustee to sell the property on default, thus doing away with the need for any court filings. The disinterested third party making sure things are done properly becomes the trustee, not a judge. In thirty states and the District of Columbia—more than half of US jurisdictions—the deed of trust is usually used in lieu of mortgages.The states using the deed of trust system are as follows: Alabama, Alaska, Arkansas, Arizona, California, Colorado, District of Columbia, Georgia, Hawaii, Idaho, Iowa, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, North Carolina, Oklahoma, Oregon, Rhode Island, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.

But the deed of trust may have certain disadvantages as well. For example, when the debt has been fully paid, the trustee will not release the deed of trust until she sees that all notes secured by it have been marked canceled. Should the borrower have misplaced the canceled notes or failed to keep good records, he will need to procure a surety bond to protect the trustee in case of a mistake. This can be an expensive procedure. In many jurisdictions, the mortgage holder is prohibited from seeking a deficiency judgment if the holder chooses to sell the property through nonjudicial means.

Installment or Land Contract

Under the installment contract or land contract, the purchaser takes possession and agrees to pay the seller over a period of years. Until the final payment, title belongs to the seller. The contract will specify the type of deed to be conveyed at closing, the terms of payment, the buyer's duty to pay taxes and insure the premises, and the seller's right to accelerate on default. The buyer's particular concern in this type of sale is whether the seller in fact has title. The buyers can protect themselves by requiring proof of title and title insurance when the contract is signed. Moreover, the buyer should record the installment contract to protect against the seller's attempt to convey title to an innocent third-party purchaser while the contract is in effect.

The benefit to the land contract is that the borrower need not bank-qualify, so the pool of available buyers is larger, and buyers who have inadequate resources at the time of contracting but who have the expectation of a rising income in the future are good candidates for the land contract. Also, the seller gets all the interest paid by the buyer, instead of the bank getting it in the usual mortgage. The obvious disadvantage from the seller's point is that she will not get a big lump sum immediately: the payments trickle in over years (unless she can sell the contract to a third party, but that would be at a discount).

Key Takeaway

The general rule on priority in real property security is that the first creditor to record its interest prevails over subsequent creditors. There are some exceptions; the most familiar is that the seller of a fixture on a purchase-money security interest has priority over a previously recorded mortgagee. The mortgage will terminate by payment, assumption by a new buyer (with a novation releasing the old buyer), and foreclosure. In a judicial-sale foreclosure, a court authorizes the property's sale; in a power-of-sale foreclosure, no court approval is required. In most states, the mortgagor whose property was foreclosed is given some period of time—six months or a year—to redeem the property; otherwise, the sale is done, but the debtor may be liable for the deficiency, if any. The deed of trust avoids any judicial involvement by having the borrower convey the land to a disinterested trustee for the benefit of the

lender; the trustee sells it upon default, with the proceeds (after expenses) going to the lender. Another method of real property security is a land contract: title shifts to the buyer only at the end of the term of payments.

Exercises

1. A debtor borrowed $350,000 to finance the purchase of a house, and the bank recorded its interest on July 1. On July 15, the debtor bought $10,000 worth of replacement windows from Window Co.; Window Co. recorded its purchase-money security interest that day, and the windows were installed. Four years later, the debtor, in hard financial times, declared bankruptcy. As between the bank and Windows Co., who will get paid first?
2. Under what interest rate circumstances would banks insist on a due-on-sale clause? Under what interest rate circumstance would banks not object to a new person assuming the mortgage?
3. What is the primary advantage of the deed of trust? What is the primary advantage of the land contract?
4. A debtor defaulted on her house payments. Under what circumstances might a court *not* allow the bank's foreclosure on the property?

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9.3: Nonconsensual Liens

Learning Objectives

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

- Understand the nonconsensual liens issued by courts—attachment liens and judgment liens—and how they are created.
- Recognize other types of nonconsensual liens: mechanic's lien, possessory lien, and tax lien.

A mortgage is obtained by the creditor with the debtor's consent. A creditor may obtain certain liens, however, without the debtor's consent.

Court-Decreed Liens

Some nonconsensual liens are issued by courts. These are important for civil litigation. A plaintiff who wins a lawsuit does not obtain payment of a jury or court award from the court. Moreover, in most cases it does not obtain immediate payment from a losing defendant. Rather, a winning plaintiff wins a judgment signed by the court. It typically includes an order for the defendant to pay the plaintiff the amount of the plaintiff's award. But, what if a defendant fails or refuses to pay the judgment? Successful plaintiffs need mechanisms to enforce their judgments against defendants. That means they must get orders from the court entitling the plaintiff to an interest in a defendant's property to secure the payment of the outstanding judgment.

Attachment Lien

An attachment lien is ordered against a person's property—real or personal—to prevent him from disposing of it during a lawsuit. To obtain an attachment lien, the plaintiff must show that the defendant likely will dispose of or hide his property; if the court agrees with the plaintiff, she must post a bond and the court will issue a writ of attachment to the sheriff, directing the sheriff to seize the property. Attachments of real property should be recorded. Should the plaintiff win her suit, the court issues a writ of execution, directing the sheriff to sell the property to satisfy the judgment.

Judgment Lien

A judgment lien may be issued when a plaintiff wins a judgment in court if an attachment lien has not already been issued. Like the attachment lien, it provides a method by which the defendant's property may be seized and sold.

Mechanic's Lien

Overview

The most common nonconsensual lien on real estate is the mechanic's lien. A mechanic's lien can be obtained by one who furnishes labor, services, or materials to improve real estate: this is statutory, and the statute must be carefully followed. The "mechanic" here is one who works with his or her hands, not specifically one who works on machines. An automobile mechanic could not obtain a mechanic's lien on a customer's house to secure payment of work he did on her car. (The lien to which the automobile mechanic is entitled is a "possessory lien" or "artisan's lien," considered in Section 12.3.3 "Possessory Lien") To qualify for a mechanic's lien, the claimant must file a sworn statement describing the work done, the contract made, or the materials furnished that permanently improved the real estate.

A particularly difficult problem crops up when the owner has paid the contractor, who in turn fails to pay his subcontractors. In many states, the subcontractors can file a lien on the owner's property, thus forcing the owner to pay them (see Figure 12.5)—and maybe twice. To protect themselves, owners can demand a sworn statement from general contractors listing the subcontractors used on the job, and from them, owners can obtain a waiver of lien rights before paying the general contractor.

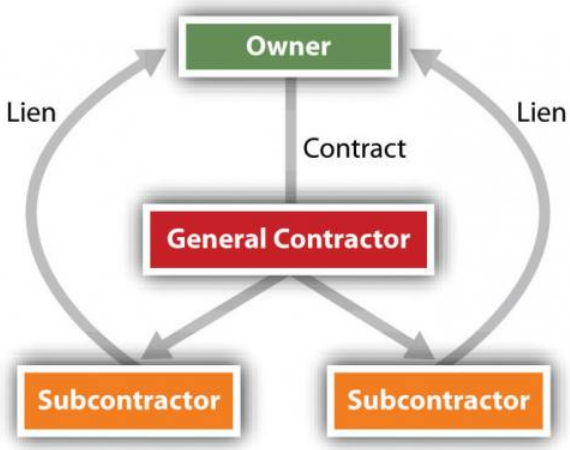


Figure 12.5 Subcontractors' Lien

Procedure for Obtaining a Mechanic's Lien

Anyone claiming a lien against real estate must record a lien statement stating the amount due and the nature of the improvement. The lienor has a specified period of time (e.g., ninety days) to file from the time the work is finished. Recording as such does not give the lienor an automatic right to the property if the debt remains unpaid. All states specify a limited period of time, usually one year, within which the claimant must file suit to enforce the lien. Only if the court decides the lien is valid may the property be sold to satisfy the debt. Difficult questions sometimes arise when a lien is filed against a landlord's property as a result of improvements and services provided to a tenant, as discussed in *F & D Elec. Contractors, Inc. v. Powder Coaters, Inc.*, Section 12.4.

Mechanic's Liens Priorities

A mechanic's lien represents a special risk to the purchaser of real estate or to lenders who wish to take a mortgage. In most states, the mechanic's lien is given priority not from the date when the lien is recorded but from an earlier date—either the date the contractor was hired or the date construction began. Thus a purchaser or lender might lose priority to a creditor with a mechanic's lien who filed after the sale or mortgage. A practical solution to this problem is to hold back part of the funds (purchase price or loan) or place them in escrow until the period for recording liens has expired.

Possessory Lien

The most common nonconsensual lien on personal property (not real estate) is the possessory lien. This is the right to continue to keep the goods on which work has been performed or for which materials have been supplied until the owner pays for the labor or materials. The possessory lien arises both under common law and under a variety of statutes. Because it is nonconsensual, the possessory lien is not covered by Article 9 of the UCC, which is restricted to consensual security interests. Nor is it governed by the law of mechanic's liens, which are nonpossessory and relate only to work done to improve real property.

The common-law rule is that anyone who, under an express or implied contract, adds value to another's chattel (personal property) by labor, skill, or materials has a possessory lien for the value of the services. Moreover, the lienholder may keep the chattel until her services are paid. For example, the dry cleaner shop is not going to release the wool jacket that you took in for cleaning unless you make satisfactory arrangements to pay for it, and the chain saw store won't let you take the chain saw that you brought in for a tune-up until you pay for the labor and materials for the tune-up.

Tax Lien

An important statutory lien is the federal tax lien. Once the government assesses a tax, the amount due constitutes a lien on the owner's property, whether real or personal. Until it is filed in the appropriate state office, others take priority, including purchasers, mechanics' lienors, judgment lien creditors, and holders of security interests. But once filed, the tax lien takes priority over all subsequently arising liens. Federal law exempts some property from the tax lien; for example, unemployment benefits, books and tools of a trade, workers' compensation, judgments for support of minor children, minimum amounts of wages and salary, personal effects, furniture, fuel, and provisions are exempt.

Local governments also can assess liens against real estate for failure to pay real estate taxes. After some period of time, the real estate may be sold to satisfy the tax amounts owing. In California, a lien to secure the payment of real estate taxes attaches to all land annually on January 1 at 12:01 a.m. (Cal. Rev. & Tax. Code, § 2192.)

Key Takeaway

There are four types of nonconsensual liens: (1) court-decreed liens are attachment liens, which prevent a person from disposing of assets pending a lawsuit, and judgment liens, which allow the prevailing party in a lawsuit to take property belonging to the debtor to satisfy the judgment; (2) mechanics' liens are authorized by statute, giving a person who has provided labor or material to a landowner the right to sell the property to get paid; (3) possessory liens on personal property allow one in possession of goods to keep them to satisfy a claim for work done or storage of them; and (4) tax liens are enforced by the government to satisfy outstanding tax liabilities and may be assessed against real or personal property.

Exercises

1. The mortgagor's interests are protected in a judicial foreclosure by a court's oversight of the process; how is the mortgagor's interest protected when a deed of trust is used?
2. Why is the deed of trust becoming increasingly popular?
3. What is the rationale for the common-law possessory lien?
4. Mike Mechanic repaired Alice Ace's automobile in his shop, but Alice didn't have enough money to pay for the repairs. May Mike have a mechanic's lien on the car? A possessory lien?
5. Why does federal law exempt unemployment benefits, books and tools of a trade, workers' compensation, minimum amounts of wages and salary, personal effects, furniture, fuel, and other such items from the sweep of a tax lien?

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9.4: Summary and Exercises

Summary

A mortgage is a means of securing a debt with real estate. The mortgagor, or borrower, gives the mortgage. The lender is the mortgagee, who holds the mortgage. On default, the mortgagee may foreclose the mortgage, convening the security interest into title. In many states, the mortgagor has a statutory right of redemption after foreclosure.

Various statutes regulate the mortgage business, including the Truth in Lending Act, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act, and the Home Mortgage Disclosure Act, which together prescribe a code of fair practices and require various disclosures to be made before the mortgage is created.

The mortgagor signs both a note and the mortgage at the closing. Without the note, the mortgage would secure nothing. Most notes and mortgages contain an acceleration clause, which calls for the entire principal and interest to be due, at the mortgagee's option, if the debtor defaults on any payment.

In most states, mortgages must be recorded for the mortgagee to be entitled to priority over third parties who might also claim an interest in the land. The general rule is "First in time, first in right," although there are exceptions for fixture filings and nonobligatory future advances. Mortgages are terminated by repayment, novation, or foreclosure, either through judicial sale or under a power-of-sale clause.

Real estate may also be used as security under a deed of trust, which permits a trustee to sell the land automatically on default, without recourse to a court of law.

Nonconsensual liens are security interests created by law. These include court-decreed liens, such as attachment liens and judgment liens. Other liens are mechanic's liens (for labor, services, or materials furnished in connection with someone's real property), possessory liens (for artisans working with someone else's personal properly), and tax liens.

Exercises

1. Able bought a duplex from Carr, who had borrowed from First Bank for its purchase. Able took title subject to Carr's mortgage. Able did not make mortgage payments to First Bank; the bank foreclosed and sold the property, leaving a deficiency. Which is correct?
    1. Carr alone is liable for the deficiency.
    2. Able alone is liable for the deficiency because he assumed the mortgage.
    3. First Bank may pursue either Able or Carr.
    4. Only if Carr fails to pay will Able be liable.
2. Harry borrowed $175,000 from Judith, giving her a note for that amount and a mortgage on his condo. Judith did not record the mortgage. After Harry defaulted on his payments, Judith began foreclosure proceedings. Harry argued that the mortgage was invalid because Judith had failed to record it. Judith counterargues that because a mortgage is not an interest in real estate, recording is not necessary. Who is correct? Explain.
3. Assume in Exercise 2 that the documents did not contain an acceleration clause and that Harry missed three consecutive payments. Could Judith foreclose? Explain.
4. Rupert, an automobile mechanic, does carpentry work on weekends. He built a detached garage for Clyde for $20,000. While he was constructing the garage, he agreed to tune up Clyde's car for an additional $200. When the work was completed, Clyde failed to pay him the $20,200, and Rupert claimed a mechanic's lien on the garage and car. What problems, if any, might Rupert encounter in enforcing his lien? Explain.
5. In Exercise 4, assume that Clyde had borrowed $50,000 from First Bank and had given the bank a mortgage on the property two weeks after Rupert commenced work on the garage but several weeks before he filed the lien. Assuming that the bank immediately recorded its mortgage and that Rupert's lien is valid, does the mortgage take priority over the lien? Why?
6. Defendant purchased a house from Seller and assumed the mortgage indebtedness to Plaintiff. All monthly payments were made on time until March 25, 1948, when no more were made. On October 8, 1948, Plaintiff sued to foreclose and accelerate the note. In February of 1948, Plaintiff asked to obtain a loan elsewhere and pay him off; he offered a discount if she would do so, three times, increasing the amount offered each time. Plaintiff understood that Defendant was getting a loan from the Federal

Housing Administration (FHA), but she was confronted with a number of requirements, including significant property improvements, which—because they were neighbors—Plaintiff knew were ongoing. While the improvements were being made, in June or July, he said to her, “Just let the payments go and we’ll settle everything up at the same time,” meaning she need not make monthly payments until the FHA was consummated, and he’d be paid from the proceeds. But then “he changed his tune” and sought foreclosure. Should the court order it?

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CHAPTER OVERVIEW

10: Bankruptcy

Learning Objectives

After reading this chapter, you should understand the following:

- A short history of US bankruptcy law
- An overview of key provisions of the 2005 bankruptcy act
- The basic operation of Chapter 7 bankruptcy
- The basic operation of Chapter 11 bankruptcy
- The basic operation of Chapter 13 bankruptcy
- What debtor's relief is available outside of bankruptcy

Bankruptcy is understood as an aspect of financing, that conceptually is a system that permits creditors to receive an equitable distribution of the bankrupt person's assets and promises new hope to debtors facing impossible financial burdens. Without such a law, we may reasonably suppose that the level of economic activity would be far less than it is, for few would be willing to risk being personally burdened forever by crushing debt. Bankruptcy gives the honest debtor a fresh start and resolves disputes among creditors.

10.1: Introduction to Bankruptcy and Overview of the 2005 Bankruptcy Act

10.2: Case Administration; Creditors' Claims; Debtors' Exemptions and Dischargeable Debts; Debtor's Estate

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10.1: Introduction to Bankruptcy and Overview of the 2005 Bankruptcy Act

Learning Objectives

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

- Understand what law governs bankruptcy in the United States.
- Know the key provisions of the law.

The Purpose of Bankruptcy Law

Bankruptcy law governs the rights of creditors and insolvent debtors who cannot pay their debts. In broadest terms, bankruptcy deals with the seizure of the debtor's assets and their distribution to the debtor's various creditors. The term derives from the Renaissance custom of Italian traders, who did their trading from benches in town marketplaces. Creditors literally "broke the bench" of a merchant who failed to pay his debts. The term *banco rotta* (broken bench) thus came to apply to business failures.

In the Victorian era, many people in both England and the United States viewed someone who became bankrupt as a wicked person. In part, this attitude was prompted by the law itself, which to a greater degree in England and to a lesser degree in the United States treated the insolvent debtor as a sort of felon. Until the second half of the nineteenth century, British insolvents could be imprisoned; jail for insolvent debtors was abolished earlier in the United States. And the entire administration of bankruptcy law favored the creditor, who could with a mere filing throw the financial affairs of the alleged insolvent into complete disarray.

Today a different attitude prevails. Bankruptcy is understood as an aspect of financing, a system that permits creditors to receive an equitable distribution of the bankrupt person's assets and promises new hope to debtors facing impossible financial burdens. Without such a law, we may reasonably suppose that the level of economic activity would be far less than it is, for few would be willing to risk being personally burdened forever by crushing debt. Bankruptcy gives the honest debtor a fresh start and resolves disputes among creditors.

History of the Bankruptcy System; Bankruptcy Courts and Judges

Constitutional Basis

The US Constitution prohibits the states from impairing the "obligation of a contract." This means that no state can directly provide a means for discharging a debtor unless the debt has been entirely paid. But the Constitution in Article I, Section 8, does give the federal government such a power by providing that Congress may enact a uniform bankruptcy law.

Bankruptcy Statutes

Congress passed bankruptcy laws in 1800, 1841, and 1867. These lasted only a few years each. In 1898, Congress enacted the Bankruptcy Act, which together with the Chandler Act amendments in 1938, lasted until 1978. In 1978, Congress passed the Bankruptcy Reform Act, and in 2005, it adopted the current law, the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). This law is the subject of our chapter.

At the beginning of the twentieth century, bankruptcies averaged fewer than 20,000 per year. Even in 1935, at the height of the Great Depression, bankruptcy filings in federal court climbed only to 69,000. At the end of World War II, in 1945, they stood at 13,000. From 1950 on, the statistics show a steep increase. During the decade before the 1978 changes, bankruptcy filings in court averaged 181,000 a year—reaching a high of 254,000 in 1975. They soared to over 450,000 filings per year in the 1980s and mostly maintained that pace until just before the 2005 law took effect (see Figure 13.1). The 2005 act—preceded by "massive lobbying largely by banks and credit card companies" (CCH Bankruptcy Reform Act Briefing, "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005," April 2005) was intended by its promoters to restore personal responsibility and integrity in the bankruptcy system. The law's critics said it was simply a way for the credit card industry to extract more money from consumers before their debts were wiped away.

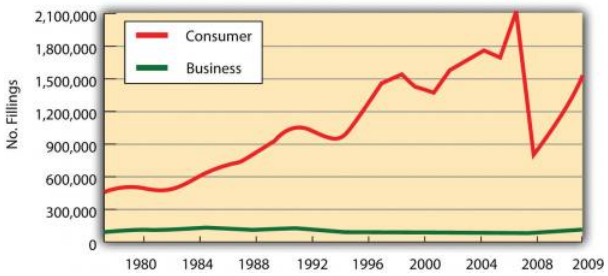


Figure 13.1 US Bankruptcies, 1980–2009

Bankruptcy Action.com, www.bankruptcyaction.com/USbankstats.htm, statistics from Administrative Office of the Courts. In 2025, the total number of filings was approximately 550,000, with consumers constituting about 95% of those filings.

Bankruptcy Courts, Judges, and Costs

Each federal judicial district has a US Bankruptcy Court, whose judges are appointed by US Courts of Appeal. Unless both sides agree otherwise, bankruptcy judges are to hear only bankruptcy matters (called core proceedings). Bankruptcy trustees are government lawyers appointed by the US Attorney General. They have administrative responsibilities in overseeing the proceedings.

The filing fee for a bankruptcy is about $325, depending upon the type of bankruptcy, and the typical lawyer's fee for uncomplicated cases is about $1,200–$2,500.

Overview of Bankruptcy Provisions

The BAPCPA provides for six different kinds of bankruptcy proceedings. Each is covered by its own chapter in the act and is usually referred to by its chapter number (see Figure 13.2).

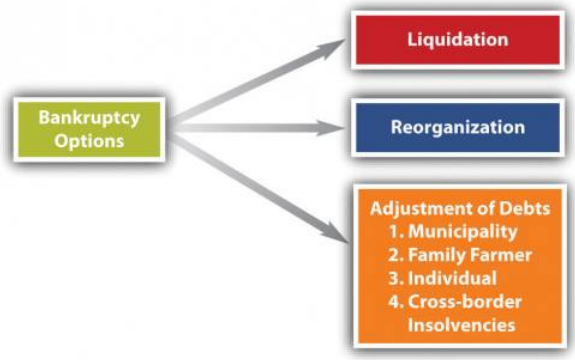


Figure 13.2 Bankruptcy Options

The bankruptcy statute (as opposed to case law interpreting it) is usually referred to as the Bankruptcy Code. The types of bankruptcies are as follows (with the most significant chapters for our discussion featured in bold typeface):

- **Chapter 7**, Liquidation: applies to all debtors except railroads, insurance companies, most banks and credit unions, and homestead associations.11 United States Code, Section 109(b). A liquidation is a "straight" bankruptcy proceeding. It entails selling the debtor's nonexempt assets for cash and distributing the cash to the creditors, thereby discharging the insolvent person or business from any further liability for the debt. About 70 percent of all bankruptcy filings are Chapter 7.
- Chapter 9, Adjustment of debts of a municipality: applies to municipalities that are insolvent and want to adjust their debts.11 United States Code, Section 109(c). (The law does not suppose that a town, city, or county will go out of existence in the wake of insolvency.)
- **Chapter 11**, Reorganization: applies to anybody who could file Chapter 7, plus railroads. It is the means by which a financially troubled company can continue to operate while its financial affairs are put on a sounder basis. A business might liquidate following reorganization but will probably take on new life after negotiations with creditors on how the old debt is to be paid

off. A company may voluntarily decide to seek Chapter 11 protection in court, or it may be forced involuntarily into a Chapter 11 proceeding.

- Chapter 12, Adjustment of debts of a family farmer or fisherman with regular annual income.11 United States Code, Section 109(f). Many family farmers cannot qualify for reorganization under Chapter 13 because of the low debt ceiling, and under Chapter 11, the proceeding is often complicated and expensive. As a result, Congress created Chapter 12, which applies only to farmers whose total debts do not exceed $1.5 million.
- **Chapter 13**, Adjustment of debts of an individual with regular income: applies only to individuals (no corporations or partnerships) with debt not exceeding about $1.3 million.11 United States Code, Section 109(e). This chapter permits an individual with regular income to establish a repayment plan, usually either a composition (an agreement among creditors, discussed in Section 13.5, "Alternatives to Bankruptcy") or an extension (a stretch-out of the time for paying the entire debt).
- Chapter 15, Ancillary and other cross-border cases: incorporates the United Nations' Model Law on Cross-Border Insolvency to promote cooperation among nations involved in cross-border cases and is intended to create legal certainty for trade and investment. "Ancillary" refers to the possibility that a US debtor might have assets or obligations in a foreign country; those non-US aspects of the case are "ancillary" to the US bankruptcy case.

The BAPCPA includes three chapters that set forth the procedures to be applied to the various proceedings. Chapter 1, "General Provisions," establishes who is eligible for relief under the act. Chapter 3, "Case Administration," spells out the powers of the various officials involved in the bankruptcy proceedings and establishes the methods for instituting bankruptcy cases. Chapter 5, "Creditors, the Debtor, and the Estate," deals with the debtor's "estate"—his or her assets. It lays down ground rules for determining which property is to be included in the estate, sets out the powers of the bankruptcy trustee to "avoid" (invalidate) transactions by which the debtor sought to remove property from the estate, orders the distribution of property to creditors, and sets forth the duties and benefits that accrue to the debtor under the act.

To illustrate how these procedural chapters (especially Chapter 3 and Chapter 5) apply, we focus on the most common proceeding: liquidation (Chapter 7). Most of the principles of bankruptcy law discussed in connection with liquidation apply to the other types of proceedings as well. However, some principles vary, and we conclude the chapter by noting special features of two other important proceedings—Chapter 13 and Chapter 11.

Key Takeaway

Bankruptcy law's purpose is to give the honest debtor a fresh start and to resolve disputes among creditors. The most recent amendments to the law were effective in 2005. Bankruptcy law provides relief to six kinds of debtors: (1) Chapter 7, straight bankruptcy—liquidation—applies to most debtors (except banks and railroads); (2) Chapter 9 applies to municipalities; (3) Chapter 11 is business reorganization; (4) Chapter 12 applies to farmers; (5) Chapter 13 is for wage earners; and (6) Chapter 15 applies to cross-border bankruptcies. The bankruptcy statutes also have several chapters that cover procedures of bankruptcy proceedings.

Exercises

1. Why is bankruptcy law required in a modern capitalistic society?
2. Who does the bankruptcy trustee represent?
3. The three most commonly filed bankruptcies are Chapter 7, 11, and 13. Who gets relief under those chapters?

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10.2: Case Administration; Creditors' Claims; Debtors' Exemptions and Dischargeable Debts; Debtor's Estate

Learning Objectives

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

- Understand the basic procedures involved in administering a bankruptcy case.
- Recognize the basic elements of creditors' rights under the bankruptcy code.
- Understand the fundamentals of what property is included in the debtor's estate.
- Identify some of the debtor's exemptions—what property can be kept by the debtor.
- Know some of the debts that cannot be discharged in bankruptcy.
- Know how an estate is liquidated under Chapter 7.

Case Administration (Chapter 3 of the Bankruptcy Code)

Recall that the purpose of liquidation is to convert the debtor's assets—except those exempt under the law—into cash for distribution to the creditors and thereafter to discharge the debtor from further liability. With certain exceptions, any person may voluntarily file a petition to liquidate under Chapter 7. A "person" is defined as any individual, partnership, or corporation. The exceptions are railroads and insurance companies, banks, savings and loan associations, credit unions, and the like.

For a Chapter 7 liquidation proceeding, as for bankruptcy proceedings in general, the various aspects of case administration are covered by the bankruptcy code's Chapter 3. These include the rules governing commencement of the proceedings, the effect of the petition in bankruptcy, the first meeting of the creditors, and the duties and powers of trustees.

Commencement

The bankruptcy begins with the filing of a petition in bankruptcy with the bankruptcy court.

Voluntary and Involuntary Petitions

The individual, partnership, or corporation may file a voluntary petition in bankruptcy; 99 percent of bankruptcies are voluntary petitions filed by the debtor. But involuntary bankruptcy is possible, too, under Chapter 7 or Chapter 11. Involuntary bankruptcies are unavailable in Chapter 13 because that chapter requires human beings to use their income over a period of three to five years to repay debt. Since involuntary servitude is prohibited under the Thirteenth Amendment to the US Constitution, Chapter 13 bankruptcies must be exclusively voluntary.

The Automatic Stay

The petition—voluntary or otherwise—operates as a stay against suits or other actions against the debtor to recover claims, enforce judgments, or create liens (but not alimony collection). In other words, once the petition is filed, the debtor is freed from worry over other proceedings affecting her finances or property. No more debt collection calls! Anyone with a claim, secured or unsecured, must seek relief in the bankruptcy court. This provision in the act can have dramatic consequences. Beset by tens of thousands of products-liability suits for damages caused by asbestos, UNR Industries and Manville Corporation, the nation's largest asbestos producers, filed (separate) voluntary bankruptcy petitions in 1982; those filings automatically stayed all pending lawsuits.

First Meeting of Creditors

Once a petition in bankruptcy is filed, the court issues an order of relief, which determines that the debtor's property is subject to bankruptcy court control and creates the stay. The Chapter 7 case may be dismissed by the court if, after a notice and hearing, it finds that among other things (e.g., delay, nonpayment of required bankruptcy fees), the debts are primarily consumer debts and the debtor could pay them off—that's the 2005 act's famous "means test," discussed in Section 10.3.

Assuming that the order of relief has been properly issued, the creditors must meet within a reasonable time. The debtor is obligated to appear at the meeting and submit to examination under oath. The judge does not preside and, indeed, is not even entitled to attend the meeting.

When the judge issues an order for relief, an interim trustee is appointed who is authorized initially to take control of the debtor's assets. The trustee is required to collect the property, liquidate the debtor's estate, and distribute the proceeds to the creditors. The trustee may sue and be sued in the name of the estate. Under every chapter except Chapter 7, the court has sole discretion to name the trustee. Under Chapter 7, the creditors may select their own trustee as long as they do it at the first meeting of creditors and follow the procedures laid down in the act.

Trustee's Powers and Duties

The act empowers the trustee to use, sell, or lease the debtor's property in the ordinary course of business or, after notice and a hearing, even if not in the ordinary course of business. In all cases, the trustee must protect any security interests in the property. As long as the court has authorized the debtor's business to continue, the trustee may also obtain credit in the ordinary course of business. She may invest money in the estate to yield the maximum, but reasonably safe, return. Subject to the court's approval, she may employ various professionals, such as attorneys, accountants, and appraisers, and may, with some exceptions, assume or reject executory contracts and unexpired leases that the debtor has made. The trustee also has the power to avoid many prebankruptcy transactions in order to recover property of the debtor to be included in the liquidation.

Creditors' Claims, the Debtor, and the Estate (Chapter 5 of the Bankruptcy Code)

We now turn to the major matters covered in Chapter 5 of the bankruptcy act: creditors' claims, debtors' exemptions and discharge, and the property to be included in the estate. We begin with the rules governing proof of claims by creditors and the priority of their claims.

Claims and Creditors

A claim is defined as a right to payment, whether or not it is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured. A creditor is defined as a person or entity with a claim that arose no later than when the court issues the order for relief. These are very broad definitions, intended to give the debtor the broadest possible relief when finally discharged.

Proof of Claims

Before the trustee can distribute proceeds of the estate, unsecured creditors must file a proof of claim, prima facie evidence that they are owed some amount of money. They must do so within six months after the first date set for the first meeting of creditors. A creditor's claim is disallowed, even though it is valid, if it is not filed in a timely manner. A party in interest, such as the trustee or creditor, may object to a proof of claim, in which case the court must determine whether to allow it. In the absence of objection, the claim is "deemed allowed." The court will not allow some claims. These include unenforceable claims, claims for unmatured interest, claims that may be offset by debts the creditor owes the debtor, and unreasonable charges by an insider or an attorney. If it's a "no asset" bankruptcy—most are—creditors are in effect told by the court not to waste their time filing proof of claim.

Claims with Priority

The bankruptcy act sets out categories of claimants and establishes priorities among them. The law is complex because it sets up different orders of priorities.

First, *secured creditors* get their security interests before anyone else is satisfied, because the security interest is not part of the property that the trustee is entitled to bring into the estate. This is why being a secured creditor is important. To the extent that secured creditors have claims in excess of their collateral, they are considered unsecured or general creditors and are lumped in with general creditors of the appropriate class.

Second, of the six classes of claimants (see Figure 13.3), the first is known as that of "*priority claims*." It is subdivided into ten categories ranked in order of priority. The highest-priority class within the general class of priority claims must be paid off in full before the next class can share in a distribution from the estate, and so on. Within each class, members will share pro rata if there are not enough assets to satisfy everyone fully. The priority classes, from highest to lowest, are set out in the bankruptcy code (11 USC Section 507) as follows:

(1) *Domestic support obligations* ("DSO"), which are claims for support due to the spouse, former spouse, child, or child's representative, and at a lower priority within this class are any claims by a governmental unit that has rendered support assistance

to the debtor's family obligations.

(2) *Administrative expenses* that are required to administer the bankruptcy case itself. Under former law, administrative expenses had the highest priority, but Congress elevated domestic support obligations above administrative expenses with the passage of the BAPCPA. Actually, though, administrative expenses have a de facto priority over domestic support obligations, because such expenses are deducted before they are paid to DSO recipients. Since trustees are paid from the bankruptcy estate, the courts have allowed de facto top priority for administrative expenses because no trustee is going to administer a bankruptcy case for nothing (and no lawyer will work for long without getting paid, either).

(3) *Gap creditors*. Claims made by gap creditors in an involuntary bankruptcy petition under Chapter 7 or Chapter 11 are those that arise between the filing of an involuntary bankruptcy petition and the order for relief issued by the court. These claims are given priority because otherwise creditors would not deal with the debtor, usually a business, when the business has declared bankruptcy but no trustee has been appointed and no order of relief issued.

(4) *Employee wages* up to $10,950 for each worker, for the 180 days previous to either the bankruptcy filing or when the business ceased operations, whichever is earlier (180-day period).

(5) *Unpaid contributions to employee benefit plans* during the 180-day period, but limited by what was already paid by the employer under subsection (4) above plus what was paid on behalf of the employees by the bankruptcy estate for any employment benefit plan.

(6) *Any claims for grain from a grain producer or fish from a fisherman* for up to $5,400 each against a storage or processing facility.

(7) *Consumer layaway deposits* of up to $2,425 each.

(8) *Taxes owing to federal, state, and local governments* for income, property, employment and excise taxes. Outside of bankruptcy, taxes usually have a higher priority than this, which is why many times creditors—not tax creditors—file an involuntary bankruptcy petition against the debtor so that they have a higher priority in bankruptcy than they would outside it.

(9) *Allowed claims based on any commitment by the debtor to a federal depository institution* to maintain the capital of an insured depository institution.

(10) *Claims for death or personal injury from a motor vehicle or vessel that occurred while the debtor was legally intoxicated.*

Third through sixth (after secured creditors and priority claimants), other claimants are attended to, but not immediately. The bankruptcy code (perhaps somewhat awkwardly) deals with who gets paid when in more than one place. Chapter 5 sets out priority *claims* as just noted; that order applies to *all* bankruptcies. Chapter 7, dealing with liquidation (as opposed to Chapter 11 and Chapter 13, wherein the debtor pays most of her debt), then lists the order of *distribution*. Section 726 of 11 United States Code provides: "Distribution of property of the estate. (1) First, in payment of claims of the kind specified in, and in the order specified in section 507…" (again, the priority of claims just set out). Following the order specified in the bankruptcy code, our discussion of the order of distribution is taken up in Section 13.3.

Debtor's Duties and Exemptions

The act imposes certain duties on the debtor, and it exempts some property that the trustee can accumulate and distribute from the estate.

Debtor's Duties

The debtor, reasonably enough, is supposed to file a list of creditors, assets, liabilities, and current income, and a statement of financial affairs. The debtor must cooperate with the trustee and be an "honest debtor" in general; the failure to abide by these duties is grounds for a denial of discharge.

The individual debtor (not including partnerships or corporations) also must show evidence that he or she attended an approved nonprofit budget and counseling agency within 180 days before the filing. The counseling may be "an individual or group briefing (including a briefing conducted by telephone or on the Internet) that outline[s] the opportunities for available credit counseling and assisted such individual in performing a related budget analysis."11 United States Code, Section 109(h). In Section 111, the 2005 act describes who can perform this counseling, and a host of regulations and enforcement mechanisms are instituted, generally

applying to persons who provide goods or services related to bankruptcy work for consumer debtors whose nonexempt assets are less than $150,000, in order to improve the professionalism of attorneys and others who work with debtors in, or contemplating, bankruptcy. A debtor who is incapacitated, disabled, or on active duty in a military zone doesn't have to go through the counseling.

Debtor's Exemptions

The bankruptcy act exempts certain property of the estate of an individual debtor so that he or she will not be impoverished upon discharge. Exactly what is exempt depends on state law.

Notwithstanding the Constitution's mandate that Congress establish "uniform laws on the subject of bankruptcies," bankruptcy law is in fact not uniform because the states persuaded Congress to allow nonuniform exemptions. The concept makes sense: what is necessary for a debtor in Maine to live a nonimpoverished postbankruptcy life might not be the same as what is necessary in southern California. The bankruptcy code describes how a person's residence is determined for claiming state exemptions: basically, where the debtor lived for 730 days immediately before filing or where she lived for 180 days immediately preceding the 730-day period. For example, if the debtor resided in the same state, without interruption, in the two years leading up to the bankruptcy, he can use that state's exemptions. If not, the location where he resided for a majority of the half-year preceding the initial two years will be used. The point here is to reduce "exemption shopping"—to reduce the incidences in which a person moves to a generous exemption state only to declare bankruptcy there.

Unless the state has opted out of the federal exemptions (a majority have), a debtor can choose which exemptions to claim.These are the states that allow residents to chose either federal or state exemptions (the other states mandate the use of state exemptions only): Arkansas, Connecticut, District of Columbia, Hawaii, Kentucky, Massachusetts, Michigan, Minnesota, New Hampshire, New Jersey, New Mexico, Pennsylvania, Rhode Island, Texas, Vermont, Washington, and Wisconsin. There are also some exemptions not included in the bankruptcy code: veteran's, Social Security, unemployment, and disability benefits are outside the code, and alimony payments are also exempt under federal law. The federal exemptions can be doubled by a married couple filing together.

Here are the federal exemptions:11 United States Code, Section 522.

Homestead:

- Real property, including mobile homes and co-ops, or burial plots up to $20,200. Unused portion of homestead, up to $10,125, may be used for other property.

Personal Property:

- Motor vehicle up to $3,225.
- Animals, crops, clothing, appliances and furnishings, books, household goods, and musical instruments up to $525 per item, and up to $10,775 total.
- Jewelry up to $1,350.
- $1,075 of any property, and unused portion of homestead up to $10,125.
- Health aids.
- Wrongful death recovery for person you depended upon.
- Personal injury recovery up to $20,200 except for pain and suffering or for pecuniary loss.
- Lost earnings payments.

Pensions:

- Tax exempt retirement accounts; IRAs and Roth IRAs up to $1,095,000 per person.

Public Benefits:

- Public assistance, Social Security, Veteran's benefits, Unemployment Compensation.
- Crime victim's compensation.

Tools of Trade:

- Implements, books, and tools of trade, up to $2,025.

Alimony and Child Support:

- Alimony and child support needed for support.

Insurance:

- Unmatured life insurance policy except credit insurance.
- Life insurance policy with loan value up to $10,775.
- Disability, unemployment, or illness benefits.
- Life insurance payments for a person you depended on, which you need for support.

In the run-up to the 2005 changes in the bankruptcy law, there was concern that some states—especially FloridaThe Florida homestead exemption is "[r]eal or personal property, including mobile or modular home and condominium, to unlimited value. Property cannot exceed: 1/2 acre in a municipality, or 160 acres elsewhere." The 2005 act limits the state homestead exemptions, as noted.—had gone too far in giving debtors' exemptions. The BAPCPA amended Section 522 to limit the amount of equity a debtor can exempt, even in a state with unlimited homestead exemptions, in certain circumstances. (Section 522(o) and (p) set out the law's changes.)

Secured Property

As already noted, secured creditors generally have priority, even above the priority claims. That's why banks and lending institutions almost always secure the debtor's obligations. But despite the general rule, the debtor can avoid certain types of security interests. Liens that attach to assets that the debtor is entitled to claim as exempt can be avoided to the extent the lien impairs the value of the exemption in both Chapter 13 and Chapter 7. To be avoidable, the lien must be a judicial lien (like a judgment or a garnishment), or a nonpossessory, non-purchase-money security interest in household goods or tools of the trade.

Tax liens (which are statutory liens, not judicial liens) aren't avoidable in Chapter 7 even if they impair exemptions; tax liens can be avoided in Chapter 13 to the extent the lien is greater than the asset's value.

Dischargeable and Nondischargeable Debts

The whole point of bankruptcy, of course, is for debtors to get relief from the press of debt that they cannot reasonably pay.

Dischargeable Debts

Once discharged, the debtor is no longer legally liable to pay any remaining unpaid debts (except nondischargeable debts) that arose before the court issued the order of relief. The discharge operates to void any money judgments already rendered against the debtor and to bar the judgment creditor from seeking to recover the judgment.

Nondischargeable Debts

Some debts are not dischargeable in bankruptcy. A bankruptcy discharge varies, depending on the type of bankruptcy the debtor files (Chapter 7, 11, 12, or 13). The most common nondischargeable debts listed in Section 523 include the following:

- All debts not listed in the bankruptcy petition
- Student loans—unless it would be an undue hardship to repay them (see Section 13.6, *In re Zygarewicz*)
- Taxes—federal, state, and municipal
- Fines for violating the law, including criminal fines and traffic tickets
- Alimony and child support, divorce, and other property settlements
- Debts for personal injury caused by driving, boating, or operating an aircraft while intoxicated
- Consumer debts owed to a single creditor and aggregating more than $550 for luxury goods or services incurred within ninety days before the order of relief
- Cash advances aggregating more than $825 obtained by an individual debtor within ninety days before the order for relief
- Debts incurred because of fraud or securities law violations
- Debts for willful injury to another's person or his or her property
- Debts from embezzlement

This is not an exhaustive list, and as noted in Section 13.3, there are some circumstances in which it is not just certain debts that aren't dischargeable: sometimes a discharge is denied entirely.

Reaffirmation

A debtor may reaffirm a debt that was discharged. Section 524 of the bankruptcy code provides important protection to the debtor intent on doing so. No reaffirmation is binding unless the reaffirmation was made *prior* to the granting of the discharge; the reaffirmation agreement must contain a clear and conspicuous statement that advises the debtor that the agreement is not required by bankruptcy or nonbankruptcy law and that the agreement may be rescinded by giving notice of rescission to the holder of such claim at any time prior to discharge or within sixty days after the agreement is filed with the court, whichever is later.

A written agreement to reaffirm a debt must be filed with the bankruptcy court. The attorney for the debtor must file an affidavit certifying that the agreement represents a fully informed and voluntary agreement, that the agreement does not impose an undue hardship on the debtor or a dependent of the debtor, and that the attorney has fully advised the debtor of the legal consequences of the agreement and of a default under the agreement. Where the debtor is an individual who was not represented by an attorney during the course of negotiating the agreement, the reaffirmation agreement must be approved by the court, after disclosures to the debtor, and after the court finds that it is in the best interest of the debtor and does not cause an undue hardship on the debtor or a dependent.

Property Included in the Estate

When a bankruptcy petition is filed, a debtor's estate is created consisting of all the debtor's then-existing property interests, whether legal or equitable. In addition, the estate includes any bequests, inheritances, and certain other distributions of property that the debtor receives within the next 180 days. It also includes property recovered by the trustee under certain powers granted by the law. What is not exempt property will be distributed to the creditors.

The bankruptcy code confers on the trustee certain powers to recover property for the estate that the debtor transferred before bankruptcy.

One such power (in Section 544) is to act as a hypothetical lien creditor. This power is best explained by an example. Suppose Dennis Debtor purchases equipment on credit from Acme Supply Company. Acme fails to perfect its security interest, and a few weeks later Debtor files a bankruptcy petition. By virtue of the section conferring on the trustee the status of a hypothetical lien creditor, the trustee can act as though she had a lien on the equipment, with priority over Acme's unperfected security interest. Thus the trustee can avoid Acme's security interest, with the result that Acme would be treated as an unsecured creditor.

Another power is to avoid transactions known as voidable preferences—transactions highly favorable to particular creditors.11 United States Code, Section 547. A transfer of property is voidable if it was made (1) to a creditor or for his benefit, (2) on account of a debt owed before the transfer was made, (3) while the debtor was insolvent, (4) on or within ninety days before the filing of the petition, and (5) to enable a creditor to receive more than he would have under Chapter 7. If the creditor was an "insider"—one who had a special relationship with the debtor, such as a relative or general partner of the debtor or a corporation that the debtor controls or serves in as director or officer—then the trustee may void the transaction if it was made within one year of the filing of the petition, assuming that the debtor was insolvent at the time the transaction was made.

Some prebankruptcy transfers that seem to fall within these provisions do not. The most important exceptions are (1) transfers made for new value (the debtor buys a refrigerator for cash one week before filing a petition; this is an exchange for new value and the trustee may not void it); (2) a transfer that creates a purchase-money security interest securing new value if the secured party perfects within ten days after the debtor receives the goods; (3) payment of a debt incurred in the ordinary course of business, on ordinary business terms; (4) transfers totaling less than $600 by an individual whose debts are primarily consumer debts; (5) transfers totaling less than $5,475 by a debtor whose debts are not primarily consumer debts; and (6) transfers to the extent the transfer was a bona fide domestic support obligation.

A third power of the trustee is to avoid fraudulent transfers made within two years before the date that the bankruptcy petition was filed.11 United States Code, Section 548. This provision contemplates various types of fraud. For example, while insolvent, the debtor might transfer property to a relative for less than it was worth, intending to recover it after discharge. This situation should be distinguished from the voidable preference just discussed, in which the debtor pays a favored creditor what he actually owes but in so doing cannot then pay other creditors.

Key Takeaway

A bankruptcy commences with the filing of a petition of bankruptcy. Creditors file proofs of claim and are entitled to certain priorities: domestic support obligations and the costs of administration are first. The debtor has an obligation to file full and truthful schedules and to attend a credit counseling session, if applicable. The debtor has a right to claim exemptions, federal or state, that leave her with assets sufficient to make a fresh start: some home equity, an automobile, and clothing and personal effects, among others. The honest debtor is discharged of many debts, but some are nondischargeable, among them taxes, debt from illegal behavior (embezzlement, drunk driving), fines, student loans, and certain consumer debt. A debtor may, after proper counseling, reaffirm debt, but only before filing. The bankruptcy trustee takes over the nonexempt property of the debtor; he may act as a hypothetical lien creditor (avoiding unperfected security interests) and avoid preferential and fraudulent transfers that unfairly diminish the property of the estate.

Exercises

1. What is the automatic stay, and when does it arise?
2. Why are the expenses of claimants administering the bankruptcy given top priority (notwithstanding the nominal top priority of domestic support obligations)?
3. Why are debtor's exemptions not uniform? What sorts of things are exempt from being taken by the bankruptcy trustee, and why are such exemptions allowed?
4. Some debts are nondischargeable; give three examples. What is the rationale for disallowing some debts from discharge?
5. How does the law take care that the debtor is fully informed of the right *not* to reaffirm debts, and why is such care taken?
6. What is a hypothetical lien creditor? What is the difference between a preferential transfer and a fraudulent one? Why is it relevant to discuss these three things in the same paragraph?

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10.3: Chapter 7 Liquidation

Learning Objectives

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

- Recognize the grounds for a Chapter 7 case to be dismissed.
- Be familiar with the BAPCPA's means-testing requirements before Chapter 7 discharge is granted.
- Know under what circumstances a debtor will be denied discharge.
- Understand the order of distribution of the debtor's estate under Chapter 7.

Trustee's Duties under Chapter 7; Grounds for Dismissal: The Means Test

Except as noted, the provisions discussed up until now apply to each type of bankruptcy proceeding. The following discussion is limited to certain provisions under Chapter 7.

Trustee's Duties

In addition to the duties already noted, the trustee has other duties under Chapter 7. He must sell the property for money, close up the estate "as expeditiously as is compatible with the best interests of parties in interest," investigate the debtor's financial affairs, examine proofs of claims, reject improper ones, oppose the discharge of the debtor where doing so is advisable in the trustee's opinion, furnish a creditor with information about the estate and his administration (unless the court orders otherwise), file tax reports if the business continues to be operated, and make a final report and file it with the court.

Conversion

Under Section 706 of the bankruptcy code, the debtor may convert a Chapter 7 case to Chapter 11, 12, or 13 at any time. The court may order a conversion to Chapter 11 at any time upon request of a party in interest and after notice and hearing. And, as discussed next, a case may be converted from Chapter 7 to Chapter 13 if the debtor agrees, or be dismissed if he does not, in those cases where the debtor makes too much money to be discharged without it being an "abuse" under the 2005 act.

Dismissal

The court may dismiss a case for three general reasons.

The first reason is "for cause," after notice and a hearing for cause, including (1) unreasonable delay by the debtor that prejudices creditors, (2) nonpayment of any fees required, (3) failure to file required documents and schedules.

The second reason for dismissal (or, with the debtor's permission, conversion to Chapter 11 or 13) applies to debtors whose debt is primarily consumer debt: the court may—after notice and a hearing—dismiss a case if granting relief would be "an abuse of the provisions" of the bankruptcy code.

The third reason for dismissal is really the crux of the 2005 law: under it, the court will find that granting relief under Chapter 7 to a debtor whose debt is primarily consumer debt *is* "an abuse" if the debtor makes too much money. The debtor must pass a means test: If he's poor enough, he can go Chapter 7. If he is not poor enough (or if they are not, in case of a married couple), Chapter 13—making payments to creditors—is the way to go. Here is one practitioner's explanation of the means test:

To apply the means test, the courts will look at the debtor's average income for the 6 months prior to filing [not the debtor's income at the time of filing, when—say—she just lost her job] and compare it to the median income for that state. For example, the median annual income for a single wage-earner in California is $42,012. If the income is below the median, then Chapter 7 remains open as an option. If the income exceeds the median, the remaining parts of the means test will be applied.

The next step in the calculation takes monthly income less reasonable living expenses ["reasonable living expenses" are strictly calculated based on IRS standards; the figure excludes payments on the debts included in the bankruptcy], and multiplies that figure times 60. This represents the amount of income available over a 5-year period for repayment of the debt obligations.

If the income available for debt repayment over that 5-year period is $10,000 or more, then Chapter 13 will be required. In other words, anyone earning above the state median, and with at least $166.67 per month ($10,000 divided by 60) of available income,

will automatically be denied Chapter 7. So for example, if the court determines that you have $200 per month income above living expenses, $200 times 60 is $12,000. Since $12,000 is above $10,000, you're stuck with Chapter 13.

What happens if you are above the median income but do NOT have at least $166.67 per month to pay toward your debts? Then the final part of the means test is applied. If the available income is less than $100 per month, then Chapter 7 again becomes an option. If the available income is between $100 and $166.66, then it is measured against the debt as a percentage, with 25% being the benchmark.

In other words, let's say your income is above the median, your debt is $50,000, and you only have $125 of available monthly income. We take $125 times 60 months (5 years), which equals $7,500 total. Since $7,500 is less than 25% of your $50,000 debt, Chapter 7 is still a possible option for you. If your debt was only $25,000, then your $7,500 of available income would exceed 25% of your debt and you would be required to file under Chapter 13.

To sum up, first figure out whether you are above or below the median income for your state—median income figures are available at www.new-bankruptcy-law-info.com. Be sure to account for your spouse's income if you are a two-income family. Next, deduct your average monthly living expenses from your monthly income and multiply by 60. If the result is above $10,000, you're stuck with Chapter 13. If the result is below $6,000, you may still be able to file Chapter 7. If the result is between $6,000 and $10,000, compare it to 25% of your debt. Above 25%, you're looking at Chapter 13 for sure.Charles Phelan, "The New Bankruptcy Means Test Explained in Plain English," *Buzzle.com*, www.buzzle.com/editorials/1-10-2006-85999.asp.

The law also requires that attorneys sign the petition (as well as the debtor); the attorney's signature certifies that the petition is well-grounded in fact and that the attorney has no knowledge after reasonable inquiry that the schedules and calculations are incorrect. Attorneys thus have an incentive to err in favor of filing Chapter 13 instead of Chapter 7 (perhaps that was part of Congress's purpose in this section of the law).

If there's been a dismissal, the debtor and creditors have the same rights and remedies as they had prior to the case being commenced—as if the case had never been filed (almost). The debtor can refile immediately, unless the court orders a 120-day penalty (for failure to appear). In most cases, a debtor can file instantly for a Chapter 13 following a Chapter 7 dismissal.

Distribution of the Estate and Discharge; Denying Discharge

Distribution of the Estate

The estate includes all his or her assets or all their assets (in the case of a married couple) broadly defined. From the estate, the debtor removes property claimed exempt; the trustee may recapture some assets improperly removed from the estate (preferential and fraudulent transfers), and what's left is the distributable estate. It is important to note that the vast majority of Chapter 7 bankruptcies are no-asset cases—90–95 percent of them, according to one longtime bankruptcy trustee.Eugene Crane, Hearing before the Subcommittee on Commercial and Administrative Law of the Committee on the Judiciary, House of Representatives, One Hundred Tenth Congress, Second Session, *Statement to the House Judiciary Sub-Committee*, September 16, 2008; judiciary.house.gov/hearings/printers/110th/44493.PDF. That means creditors get nothing. But in those cases where there are assets, the trustee must distribute the estate to the remaining classes of claimants in this order:

1. Secured creditors, paid on their security interests
2. Claims with priority
3. Unsecured creditors who filed their claims on time
4. Unsecured creditors who were tardy in filing, if they had no notice of the bankruptcy
5. Unsecured creditors who were tardy and had notice, real or constructive
6. Claims by creditors for fines, penalties, and exemplary or punitive damages
7. Interest for all creditors at the legal rate
8. The debtor



Figure 13.3 Distribution of the Estate

Discharge

Once the estate is distributed, the court will order the debtor discharged (except for nondischargeable debts) unless one of the following overall exceptions applies for denying discharge (i.e., relief from the debt). This list is not exhaustive:

1. The debtor is not an individual. In a Chapter 7 case, a corporation or partnership does not receive a bankruptcy discharge; instead, the entity is dissolved and its assets liquidated. The debts remain theoretically valid but uncollectible until the statute of limitations on them has run. Only an individual can receive a Chapter 7 discharge.11 United States Code, Section 727(a)(1).
2. The debtor has concealed or destroyed property with intent to defraud, hinder, or delay within twelve months preceding filing of the petition.
3. The debtor has concealed, destroyed, or falsified books and records
4. The debtor has lied under oath, knowingly given a false account, presented or used a false claim, given or received bribes, refused to obey court orders.
5. The debtor has failed to explain satisfactorily any loss of assets.
6. The debtor has declared Chapter 7 or Chapter 11 bankruptcy within eight years, or Chapter 13 within six years (with some exceptions).
7. The debtor failed to participate in “an instructional course concerning personal financial management” (unless that’s excused).
8. An individual debtor has “abused” the bankruptcy process. A preferential transfer is not an “abuse,” but it will be set aside. Making too much money to file Chapter 7 is “an abuse” that will deny discharge.

A discharge may be revoked if the debtor committed fraud during the bankruptcy proceedings, but the trustee or a creditor must apply for revocation within one year of the discharge.

Having the discharge denied does not affect the administration of the bankruptcy case. The trustee can (and will) continue to liquidate any nonexempt assets of the debtor and pay the creditors, but the debtor still has to pay the debts left over.

As to any consequence of discharge, bankruptcy law prohibits governmental units from discriminating against a person who has gone through bankruptcy. Debtors are also protected from discrimination by private employers; for example, a private employer may not fire a debtor because of the bankruptcy. Certainly, however, the debtor’s credit rating will be affected by the bankruptcy.

Key Takeaway

A Chapter 7 bankruptcy case may be dismissed for cause or because the debtor has abused the system. The debtor is automatically considered to have abused the system if he makes too much money. With the debtor’s permission, the Chapter 7 may be converted to Chapter 11, 12, or 13. The law requires that the debtor pass a means test to qualify for Chapter 7. Assuming the debtor does qualify for Chapter 7, her nonexempt assets (if there are any) are sold by the trustee and distributed to creditors according to a priority set out in the law. A discharge may be denied, in general because the debtor has behaved dishonestly or—again—has abused the system.

Exercises

1. What is the difference between denial of a discharge for cause and denial for abuse?
2. What is the difference between a dismissal and a denial of discharge?
3. Which creditors get satisfied first in a Chapter 7 bankruptcy?

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10.4: Chapter 11 and Chapter 13 Bankruptcies

Learning Objectives

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

- Understand the basic concepts of Chapter 11 bankruptcies.
- Understand the basic concepts of Chapter 13 bankruptcies.

Reorganization: Chapter 11 Bankruptcy

Overview

Chapter 11 provides a means by which corporations, partnerships, and other businesses, including sole proprietorships, can rehabilitate themselves and continue to operate free from the burden of debts that they cannot pay.

It is simple enough to apply for the protection of the court in Chapter 11 proceeding, and for many years, large financially ailing companies have sought shelter in Chapter 11. Well-known examples include General Motors, Texaco, K-Mart, Delta Airlines, and Northwest Airlines. An increasing number of corporations have turned to Chapter 11 even though, by conventional terms, they were solvent. Doing so enables them to negotiate with creditors to reduce debt. It also may even permit courts to snuff out lawsuits that have not yet been filed. Chapters 3 and 5, discussed in Section 13.2, apply to Chapter 11 proceedings also. Our discussion, therefore, is limited to special features of Chapter 11.

How It Works

Eligibility

Any person eligible for discharge in Chapter 7 proceeding (plus railroads) is eligible for a Chapter 11 proceeding, except stockbrokers and commodity brokers. Individuals filing Chapter 11 must take credit counseling; businesses do not. A company may voluntarily enter Chapter 11 or may be put there involuntarily by creditors. Individuals can file Chapter 11 particularly if they have too much debt to qualify for Chapter 13 and make too much money to qualify for Chapter 7; under the 2005 act, individuals must commit future wages to creditors, just as in Chapter 13.11 United States Code, Sections 1115, 1123(a)(8), and 1129(a)(15).

Operation of Business

Unless a trustee is appointed, the debtor will retain possession of the business and may continue to operate with its own management. The court may appoint a trustee on request of any party in interest after notice and a hearing. The appointment may be made for cause—such as dishonesty, incompetence, or gross mismanagement—or if it is otherwise in the best interests of the creditors. Frequently, the same incompetent management that got the business into bankruptcy is left running it—that's a criticism of Chapter 11.

Creditors' Committee

The court must appoint a committee of unsecured creditors as soon as practicable after issuing the order for relief. The committee must consist of creditors willing to serve who have the seven largest claims, unless the court decides to continue a committee formed before the filing, if the committee was fairly chosen and adequately represents the various claims. The committee has several duties, including these: (1) to investigate the debtor's financial affairs, (2) to determine whether to seek appointment of a trustee or to let the business continue to operate, and (3) to consult with the debtor or trustee throughout the case.

The Reorganization Plan

The debtor may always file its own plan, whether in a voluntary or involuntary case. If the court leaves the debtor in possession without appointing a trustee, the debtor has the exclusive right to file a reorganization plan during the first 120 days. If it does file, it will then have another 60 days to obtain the creditors' acceptances. Although its exclusivity expires at the end of 180 days, the court may lengthen or shorten the period for good cause. At the end of the exclusive period, the creditors' committee, a single creditor, or a holder of equity in the debtor's property may file a plan. If the court does appoint a trustee, any party in interest may file a plan at any time.

The Bankruptcy Reform Act specifies certain features of the plan and permits others to be included. Among other things, the plan must (1) designate classes of claims and ownership interests; (2) specify which classes or interests are impaired—a claim or ownership interest is impaired if the creditor's legal, equitable, contractual rights are altered under the plan; (3) specify the treatment of any class of claims or interests that is impaired under the plan; (4) provide the same treatment of each claim or interests of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment; and (5) provide adequate means for carrying out the plan. Basically, what the plan does is provide a process for rehabilitating the company's faltering business by relieving it from repaying part of its debt and initiating reforms so that the company can try to get back on its feet.

Acceptance of the Plan

The act requires the plan to be accepted by certain proportions of each impaired class of claims and interests. A class of claims accepts the plan if creditors representing at least two-thirds of the dollar amount of claims and more than one-half the number of allowed claims vote in favor. A class of property interests accepts the plan if creditors representing two-thirds of the dollar amount of the allowed ownership interests vote in favor. Unimpaired classes of claims and interest are deemed to have accepted the plan; it is unnecessary to solicit their acceptance.

Confirmation of the Plan

The final act necessary under Chapter 11 is confirmation by the court. Once the court confirms the plan, the plan is binding on all creditors. The rules governing confirmation are complex, but in essence, they include the following requirements:

1. The plan must have been proposed in good faith. Companies must also make a good-faith attempt to negotiate modifications in their collective bargaining agreements (labor union contracts).
2. All provisions of the act must have been complied with.
3. The court must have determined that the reorganized business will be likely to succeed and be unlikely to require further financial reorganization in the foreseeable future.
4. Impaired classes of claims and interests must have accepted the plan, unless the plan treats them in a "fair and equitable" manner, in which case consent is not required. This is sometimes referred to as the cram-down provision.
5. All members of every class must have received no less value than they would have in Chapter 7 liquidation.

Discharge, Conversion

The debtor gets discharged when all payments under the plan are completed. A Chapter 11 bankruptcy may be converted to Chapter 7, with some restrictions, if it turns out the debtor cannot make the plan work.

Adjustment of Debts of an Individual with Regular Income: Chapter 13 Bankruptcy

In General

Anyone with a steady income who is having difficulty paying off accumulated debts may seek the protection of a bankruptcy court in Chapter 13 proceeding (often called the wage earner's plan). Under this chapter, the individual debtor presents a payment plan to creditors, and the court appoints a trustee. If the creditors wind up with more under the plan presented than they would receive in Chapter 7 proceeding, then the court is likely to approve it. In general, a Chapter 13 repayment plan extends the time to pay the debt and may reduce it so that the debtor need not pay it all. Typically, the debtor will pay a fixed sum monthly to the trustee, who will distribute it to the creditors. The previously discussed provisions of Chapters 3 and 5 apply also to this chapter; therefore, the discussion that follows focuses on some unique features of Chapter 13.

People seek Chapter 13 discharges instead of Chapter 7 for various reasons: they make too much money to pass the Chapter 7 means test; they are behind on their mortgage or car payments and want to make them up over time and reinstate the original agreement; they have debts that can't be discharged in Chapter 7; they have nonexempt property they want to keep; they have codebtors on a personal debt who would be liable if the debtor went Chapter 7; they have a real desire to pay their debts but cannot do so without getting the creditors to give them some breathing room. Chapter 7 cases may always be converted to Chapter 13.

How It Works

Eligibility

Chapter 13 is voluntary only. Anyone—sole proprietorships included—who has a regular income, unsecured debts of less than $526,000, and secured debts of less than $1,580,000 is eligible to seek its protection. The debts must be unpaid and owing at the time the debtor applies for relief. If the person has more debt than that, she will have to file Chapter 11. The debtor must attend a credit-counseling class, as in Chapter 7.

The Plan

Plans are typically extensions or compositions—that is, they extend the time to pay what is owing, or they are agreements among creditors each to accept something less than the full amount owed (so that all get something). Under Chapter 13, the stretch-out period is three to five three years. The plan must provide for payments of all future income or a sufficient portion of it to the trustee. Priority creditors are entitled to be paid in full, although they may be paid later than required under the original indebtedness. As long as the plan is being carried out, the debtor may enjoin any creditors from suing to collect the original debt.

Confirmation

Under Section 1325 of the bankruptcy code, the court must approve the plan if it meets certain requirements. These include (1) distribution of property to unsecured creditors whose claims are allowed in an amount no less than that which they would have received had the estate been liquidated under Chapter 7; (2) acceptance by secured creditors, with some exceptions, such as when the debtor surrenders the secured property to the creditor; and (3) proposal of the plan "in good faith." If the trustee or an unsecured creditor objects to confirmation, the plan must meet additional tests. For example, a plan will be approved if all of the debtor's disposable income (as defined in Section 1325) over the commitment period (three to five years) will be used to make payments under the plan.

Discharge

Once a debtor has made all payments called for in the plan, the court will discharge him from all remaining debts except certain long-term debts and obligations to pay alimony, maintenance, and support. Under former law, Chapter 13 was so broad that it permitted the court to discharge the debtor from many debts considered nondischargeable under Chapter 7, but 1994 amendments and the 2005 act made Chapter 13 less expansive. Debts dischargeable in Chapter 13, but not in Chapter 7, include debts for willful and malicious injury to property, debts incurred to pay nondischargeable tax obligations, and debts arising from property settlements in divorce or separation proceedings. (See Section 13.6, *In re Ryan*, for a discussion of what debts are dischargeable under Chapter 13 as compared with Chapter 7.)

Although a Chapter 13 debtor generally receives a discharge only after completing all payments required by the court-approved (i.e., "confirmed") repayment plan, there are some limited circumstances under which the debtor may request the court to grant a "hardship discharge" even though the debtor has failed to complete plan payments. Such a discharge is available only to a debtor whose failure to complete plan payments is due to circumstances beyond the debtor's control. A Chapter 13 discharge stays on the credit record for up to ten years.

A discharge may be denied if the debtor previously went through a bankruptcy too soon before filing Chapter 13, failed to act in good faith, or—with some exceptions—failed to complete a personal financial management course.

Key Takeaway

Chapter 11—frequently referred to as "corporate reorganization"—is most often used by businesses whose value as a going concern is greater than it would be if liquidated, but, with some exceptions, anyone eligible to file Chapter 7 can file Chapter 11. The business owners, or in some cases the trustee or creditors, develop a plan to pay the firm's debts over a three- to five-year period; the plan must be approved by creditors and the court. Chapter 13—frequently called the wage-earner's plan—is a similar mechanism by which a person can discharge some debt and have longer to pay debts off than originally scheduled. Under Chapter 13, people can get certain relief from creditors that they cannot get in Chapter 7.

Exercises

1. David Debtor is a freelance artist with significant debt that he feels a moral obligation to pay. Why is Chapter 11 his best choice of bankruptcy chapters to file under?
2. What is the practical difference between debts arising from property settlements in divorce or separation proceedings—which can be discharged under Chapter 13—and debts owing for alimony (maintenance) and child support—which cannot be discharged under Chapter 13?
3. Why would a person want to go through the long grind of Chapter 13 instead of just declaring straight bankruptcy (Chapter 7) and being done with it?

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10.5: Alternatives to Bankruptcy

Learning Objectives

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

- Understand that there are nonbankruptcy alternatives for debtors who cannot pay their bills in a timely way: assignment for benefit of creditors, compositions, and receiverships.
- Recognize the reasons why these alternatives might not work.

Alternatives to Bankruptcy: Overview

Bankruptcy is a necessary thing in a capitalist economic system. As already noted, without it, few people would be willing to take business risks, and the economy would necessarily operate at a lower level (something some people might not think so bad overall). But bankruptcy, however "enlightened" society may have become about it since Victorian days, still carries a stigma. Bankruptcy filings are public information; the lists of people and businesses who declare bankruptcy are regularly published in monthly business journals. Bankruptcy is expensive, too, and both debtors and creditors become enmeshed in significantly complex federal law. For these reasons, among others, both parties frequently determine it is in their best interest to find an alternative to bankruptcy. Here we take up briefly three common alternatives.

In other parts of this book, other nonbankruptcy creditors' rights are discussed: under the Uniform Commercial Code (UCC), creditors have rights to reclaim goods sold and delivered but not paid for; under the UCC, too, creditors have a right to repossess personal property that has been put up as collateral for the debtor's loan or extension of credit; and mortgagees have the right to repossess real estate without judicial assistance in many circumstances. These nonbankruptcy remedies are governed mostly by state law.

The nonbankruptcy alternatives discussed here are governed by state law also.

Assignment for Benefit of Creditors; Compositions; Receivership

Benefit of Creditors

Under a common-law assignment for the benefit of creditors, the debtor transfers some or all of his assets to a trustee—usually someone appointed by the adjustment bureau of a local credit managers' association—who sells the assets and apportions the proceeds in some agreed manner, usually pro rata, to the creditors. Of course, not every creditor need agree with such a distribution. Strictly speaking, the common-law assignment does not discharge the balance of the debt. Many state statutes attempt to address this problem either by prohibiting creditors who accept a partial payment of debt under an assignment from claiming the balance or by permitting debtors to demand a release from creditors who accept partial payment.

Composition Agreement

A composition agreement is simply an agreement by creditors to accept less than the full amount of the debt and to discharge the debtor from further liability. As a contract, a composition agreement requires consideration; the mutual agreement among creditors to accept a pro rata share of the proceeds is held to be sufficient consideration to support the discharge. The essential difference between assignment and a composition agreement lies in the creditors' agreement: an assignment implies no agreement among the creditors, whereas a composition agreement does. Not all creditors of the particular debtor need agree to the composition agreement for it to be valid. A creditor who does not agree to the composition agreement remains free to attempt to collect the full sum owed; in particular, a creditor not inclined to compose the debt could attach the debtor's assets while other creditors are bargaining over the details of the composition agreement.

One advantage of the assignment over the composition agreement is that in the former the debtor's assets—having been assigned—are protected from attachment by hungry creditors. Also, the assignment does not require creditors' consent. However, an advantage to the debtor of the assignment (compared with the composition) is that in the composition agreement creditors cannot go after the debtor for any deficiency (because they agreed not to).

Receivership

A creditor may petition the court to appoint a receiver; receivership is a long-established procedure in equity whereby the receiver takes over the debtor's property under instructions from the court. The receiver may liquidate the property, continue to operate the business, or preserve the assets without operating the business until the court finally determines how to dispose of the debtor's property.

The difficulty with most of the alternatives to bankruptcy lies in their voluntary character: a creditor who refuses to go along with an agreement to discharge the debtor can usually manage to thwart the debtor and her fellow creditors because, at the end of the day, the US Constitution forbids the states from impairing private citizens' contractual obligations. The only final protection, therefore, is to be found in the federal bankruptcy law.

Key Takeaway

Bankruptcy is expensive and frequently convoluted. Nonbankruptcy alternatives include assignment for the benefit of creditors (the debtor's assets are assigned to a trustee who manages or disposes of them for creditors), compositions (agreements by creditors to accept less than they are owed and to discharge the debtor from further liability), and receivership (a type of court-supervised assignment).

Exercises

1. What is an assignment for benefit of creditors?
2. What is a composition?
3. What is a receivership?
4. Why are these alternatives to bankruptcy often unsatisfactory?

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10.6: Summary and Exercises

Summary

The Constitution gives Congress the power to legislate on bankruptcy. The current law is the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which provides for six types of proceedings: (1) liquidation, Chapter 7; (2) adjustment of debts of a municipality, Chapter 9; (3) reorganization, Chapter 11; (4) family farmers with regular income, Chapter 12; (5) individuals with regular income, Chapter 13; and (6) cross-border bankruptcies, Chapter 15.

With some exceptions, any individual, partnership, or corporation seeking liquidation may file a voluntary petition in bankruptcy. An involuntary petition is also possible; creditors petitioning for that must meet certain criteria.

A petition operates as a stay against the debtor for lawsuits to recover claims or enforce judgments or liens. A judge will issue an order of relief and appoint a trustee, who takes over the debtor's property and preserves security interests. To recover monies owed, creditors must file proof of claims. The trustee has certain powers to recover property for the estate that the debtor transferred before bankruptcy. These include the power to act as a hypothetical lien creditor, to avoid fraudulent transfers and voidable preferences.

The bankruptcy act sets out categories of claimants and establishes priority among them. After secured parties take their security, the priorities are (1) domestic support obligations, (2) administrative expenses, (3) gap creditor claims, (4) employees' wages, salaries, commissions, (5) contributions to employee benefit plans, (6) grain or fish producers' claims against a storage facility, (7) consumer deposits, (8) taxes owed to governments, (9) allowed claims for personal injury or death resulting from debtor's driving or operating a vessel while intoxicated. After these priority claims are paid, the trustee must distribute the estate in this order: (a) unsecured creditors who filed timely, (b) unsecured creditors who filed late, (c) persons claiming fines and the like, (d) all other creditors, (e) the debtor. Most bankruptcies are no-asset, so creditors get nothing.

Under Chapter 7's 2005 amendments, debtors must pass a means test to be eligible for relief; if they make too much money, they must file Chapter 13.

Certain property is exempt from the estate of an individual debtor. States may opt out of the federal list of exemptions and substitute their own; most have.

Once discharged, the debtor is no longer legally liable for most debts. However, some debts are not dischargeable, and bad faith by the debtor may preclude discharge. Under some circumstances, a debtor may reaffirm a discharged debt. A Chapter 7 case may be converted to Chapter 11 or 13 voluntarily, or to Chapter 11 involuntarily.

Chapter 11 provides for reorganization. Any person eligible for discharge in Chapter 7 is eligible for Chapter 11, except stockbrokers and commodity brokers; those who have too much debt to file Chapter 13 and surpass the means test for Chapter 7 file Chapter 11. Under Chapter 11, the debtor retains possession of the business and may continue to operate it with its own management unless the court appoints a trustee. The court may do so either for cause or if it is in the best interests of the creditors. The court must appoint a committee of unsecured creditors, who remain active throughout the proceeding. The debtor may file its own reorganization plan and has the exclusive right to do so within 120 days if it remains in possession. The plan must be accepted by certain proportions of each impaired class of claims and interests. It is binding on all creditors, and the debtor is discharged from all debts once the court confirms the plan.

Chapter 13 is for any individual with regular income who has difficulty paying debts; it is voluntary only; the debtor must get credit counseling. The debtor presents a payment plan to creditors, and the court appoints a trustee. The plan extends the time to pay and may reduce the size of the debt. If the creditors wind up with more in this proceeding than they would have in Chapter 7, the court is likely to approve the plan. The court may approve a stretch-out of five years. Some debts not dischargeable under Chapter 7 may be under Chapter 13.

Alternatives to bankruptcy are (1) composition (agreement by creditors to accept less than the face amount of the debt), (2) assignment for benefit of creditors (transfer of debtor's property to a trustee, who uses it to pay debts), and (3) receivership (a disinterested person is appointed by the court to preserve assets and distribute them at the court's direction). Because these are voluntary procedures, they are ineffective if all parties do not agree to them.

Exercises

1. David has debts of $18,000 and few assets. Because his debts are less than $25,000, he decides to file for bankruptcy using the state court system rather than the federal system. Briefly describe the procedure he should follow to file for bankruptcy at the state level.
2. Assume that David in Exercise 1 is irregularly employed and has developed a plan for paying off his creditors. What type of bankruptcy should he use, Chapter 7, 11, or 13? Why?
3. Assume that David owns the following unsecured property: a $3,000 oboe, a $1,000 piano, a $2,000 car, and a life insurance policy with a cash surrender value of $8,000. How much of this property is available for distribution to his creditors in a bankruptcy? Explain.
4. If David owes his ex-wife alimony (maintenance) payments and is obligated to pay $12,000 for an educational loan, what effect will his discharge have on these obligations?
5. Assume that David owns a corporation that he wants to liquidate under Chapter 7. After the corporate assets are distributed to creditors, there is still money owing to many of them. What obstacle does David face in obtaining a discharge for the corporation?
6. The famous retired professional football player—with a pension from the NFL—Orenthal James “O.J.” Simpson was convicted of wrongful death in a celebrated Santa Monica, California, trial in 1997 and ordered to pay $33.5 million in damages to the families of the deceased. Mr. Simpson sold his California house, moved to Florida, and, from occasional appearances in the press, seemed to be living a high-style life with a big house, nice cars, and sharp clothing. He has never declared bankruptcy. Why hasn’t he been forced into an involuntary Chapter 7 bankruptcy by his creditors?
7. 1. A debtor has an automobile worth $5,000. The federal exemption applicable to her is $3,225. The trustee sells the car and gives the debtor the amount of the exemption. The debtor, exhausted by the bankruptcy proceedings, takes the $3,225 and spends it on a six-week vacation in Baja California. Is this an “abuse” of the bankruptcy system?
   2. A debtor has $500 in cash beyond what is exempt in bankruptcy. She takes the cash and buys new tires for her car, which is worth about $2,000. Is this an “abuse” of the bankruptcy system?

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CHAPTER OVERVIEW

11: Employment Law

Learning Objectives

After reading this chapter, you should understand the following:

- How common-law employment at will is modified by common-law doctrine, federal statutes, and state statutes
- Various kinds of prohibited discrimination under Title VII and examples of each kind
- The various other protections for employees imposed by federal statute, including the Age Discrimination in Employment Act (ADEA) and the Americans with Disabilities Act (ADA)

In this chapter, we will examine the laws that govern the relationship between the employer and the employee who belongs, or wants to belong, to a union. Although federal labor law is confined to that relationship, laws dealing with the employment relationship—both state and federal—are far broader than that.

11.1: Introduction to Employment Law

11.2: Federal Employment Discrimination Laws

11.3: Employment at Will

11.4: Other Employment-Related Laws

11.5: Summary and Exercises

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11.1: Introduction to Employment Law

Because most employees do not belong to unions, a host of laws dealing with the many faces of discrimination shapes employers' power over and duties to their employees. Beyond the issue of discrimination, the law also governs a number of other issues, such as the extent to which an employer may terminate the relationship itself. We examine these issues later in this chapter.

Even before statutes governing collective bargaining and various state and federal discrimination laws, the common law set the boundaries for employer-employee relationships. The basic rule that evolved prior to the twentieth century was "employment at will." We will look at employment at will toward the end of this chapter. But as we go through the key statutes on employment law and employment discrimination, bear in mind that these statutes stand as an important set of exceptions to the basic common-law rule of employment at will. That rule holds that in the absence of a contractual agreement otherwise, an employee is free to leave employment at any time and for any reason; similarly, an employer is free to fire employees at any time and for any reason (again, subject to statutory limitations).

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11.2: Federal Employment Discrimination Laws

Learning Objectives

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

- Know the various federal discrimination laws and how they are applied in various cases.
- Distinguish between disparate impact and disparate treatment cases.
- Understand the concept of affirmative action and its limits in employment law.

As we look at federal employment discrimination laws, bear in mind that most states also have laws that prohibit various kinds of discriminatory practices in employment. Until the 1960s, Congress had intruded but little in the affairs of employers except in union relationships. A company could refuse to hire members of racial minorities, exclude women from promotions, or pay men more than women for the same work. But with the rise of the civil rights movement in the early 1960s, Congress (and many states) began to legislate away the employer's frequently exercised power to discriminate. The most important statutes are Title VII of the Civil Rights Act of 1964, the Equal Pay Act of 1963, the Age Discrimination in Employment Act of 1967, and the Americans with Disabilities Act of 1990.

Importantly: this is a discussion of federal employment laws. States can, and often do, have standards that provide employees additional protections that are greater than those found in federal law. For instance, in California the Fair Employment and Housing Act (FEHA) provides broader protections to employees than its federal law counterparts. Some of those distinctions are discussed below, as relevant.

Title VII of the Civil Rights Act of 1964

The most basic antidiscrimination law in employment is in Title VII of the federal Civil Rights Act of 1964. The key prohibited discrimination is that based on race, but Congress also included sex, religion, national origin, and color as prohibited bases for hiring, promotion, layoff, and discharge decisions. To put the Civil Rights Act in its proper context, a short history of racial discrimination in the United States follows.

The passage of the Civil Rights Act of 1964 was the culmination of a long history that dated back to slavery, the founding of the US legal system, the Civil War, and many historical and political developments over the ninety-nine years from the end of the Civil War to the passage of the act. The years prior to 1964 had seen a remarkable rise of civil disobedience, led by many in the civil rights movement but most prominently by Dr. Martin Luther King Jr. Peaceful civil disobedience was sometimes met with violence, and television cameras were there to record most of it.

While the Civil War had addressed slavery and the secession of Southern states, the Thirteenth, Fourteenth, and Fifteenth Amendments, ratified just after the war, provided for equal protection under the law, guaranteed citizenship, and protected the right to vote for African Americans. The amendments also allowed Congress to enforce these provisions by enacting appropriate, specific legislation.

But during the Reconstruction Era, many of the Southern states resisted the laws that were passed in Washington, DC, to bolster civil rights. To a significant extent, decisions rendered by the US Supreme Court in this era—such as *Plessy v. Ferguson*, condoning "separate but equal" facilities for different races—restricted the utility of these new federal laws. The states effectively controlled the public treatment of African Americans, and a period of neglect set in that lasted until after World War II. The state laws essentially mandated segregated facilities (restaurants, hotels, schools, water fountains, public bathrooms) that were usually inferior for blacks.

Along with these Jim Crow laws in the South, the Ku Klux Klan was very strong, and lynchings (hangings without any sort of public due process) by the Klan and others were designed to limit the civil and economic rights of the former slaves. The hatred of blacks from that era by many whites in America has only gradually softened since 1964. Even as the civil rights bill was being debated in Congress in 1964, some would clandestinely chant "Be a man, join the Klan" and sing "We will hang Earl Warren from a sour apple tree," to the tune of "Battle Hymn of the Republic," in anger over the Chief Justice's presiding over *Brown v. Board of Education*, which reversed *Plessy v. Ferguson*.

But just a few years earlier, the public service and heroism of many black military units and individuals in World War II had created a perceptual shift in US society; men of many races who had served together in the war against the Axis powers (fascism in Europe and the Japanese emperor's rule in the Pacific) began to understand their common humanity. Major migrations of blacks from the South to industrial cities of the North also gave impetus to the civil rights movement.

Bills introduced in Congress regarding employment policy brought the issue of civil rights to the attention of representatives and senators. In 1945, 1947, and 1949, the House of Representatives voted to abolish the poll tax. The poll tax was a method used in many states to confine voting rights to those who could pay a tax, and often, blacks could not. The Senate did not go along, but these bills signaled a growing interest in protecting civil rights through federal action. The executive branch of government, by presidential order, likewise became active by ending discrimination in the nation's military forces and in federal employment and work done under government contract.

The Supreme Court gave impetus to the civil rights movement in its reversal of the "separate but equal" doctrine in the *Brown v. Board of Education* decision. In its 1954 decision, the Court said, "To separate black children from others of similar age and qualifications solely because of their race generates a feeling of inferiority as to their status in the community that may affect their hearts and minds in a way never to be undone.…We conclude that in the field of public education the doctrine of separate but equal has no place. Separate educational facilities are inherently unequal."

This decision meant that white and black children could not be forced to attend separate public schools. By itself, however, this decision did not create immediate gains, either in public school desegregation or in the desegregation of other public facilities. There were memorable standoffs between federal agents and state officials in Little Rock, Arkansas, for example; the Democratic governor of Arkansas personally blocked young black students from entering Little Rock's Central High School, and it was only President Eisenhower's order to have federal marshals accompany the students that forced integration. The year was 1957.

But resistance to public school integration was widespread, and other public facilities were not governed by the *Brown* ruling. Restaurants, hotels, and other public facilities were still largely segregated. Segregation kept blacks from using public city buses, park facilities, and restrooms on an equal basis with whites. Along with inferior schools, workplace practices throughout the South and also in many Northern cities sharply limited African Americans' ability to advance economically. Civil disobedience began to grow.

The bus protests in Montgomery, Alabama, were particularly effective. Planned by civil rights leaders, Rosa Parks's refusal to give up her seat to a white person and sit at the back of the public bus led to a boycott of the Montgomery bus system by blacks and, later, a boycott of white businesses in Montgomery. There were months of confrontation and some violence; finally, the city agreed to end its long-standing rules on segregated seating on buses.

There were also protests at lunch counters and other protests on public buses, where groups of Northern protesters—Freedom Riders—sometimes met with violence. In 1962, James Meredith's attempt to enroll as the first African American at the University of Mississippi generated extreme hostility; two people were killed and 375 were injured as the state resisted Meredith's admission. The murders of civil rights workers Medgar Evers and William L. Moore added to the inflamed sentiments, and whites in Birmingham, Alabama, killed four young black girls who were attending Sunday school when their church was bombed.

These events were all covered by the nation's news media, whose photos showed beatings of protesters and the use of fire hoses on peaceful protesters. Social tensions were reaching a postwar high by 1964. According to the government, there were nearly one thousand civil rights demonstrations in 209 cities in a three-month period beginning May 1963. Representatives and senators could not ignore the impact of social protest. But the complicated political history of the Civil Rights Act of 1964 also tells us that the legislative result was anything but a foregone conclusion.

In Title VII of the Civil Rights Act of 1964, Congress for the first time outlawed discrimination in employment based on race, religion, sex, or national origin:. Title VII declares: "It shall be an unlawful employment practice for an employer to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin." Title VII applies to (1) employers with fifteen or more employees whose business affects interstate commerce, (2) all employment agencies, (3) labor unions with fifteen or more members, (4) state and local governments and their agencies, and (5) most federal government employment.

In 1984, the Supreme Court said that Title VII applies to partnerships as well as corporations when ruling that it is illegal to discriminatorily refuse to promote a female lawyer to partnership status in a law firm. This applies, by implication, to other fields, such as accounting.*Hishon v. King & Spalding*, 467 U.S. 69 (1984). The remedy for unlawful discrimination is back pay and hiring, reinstatement, or promotion.

Title VII established the Equal Employment Opportunity Commission (EEOC) to investigate violations of the act. A victim of discrimination who wishes to file suit must first file a complaint with the EEOC to permit that agency to attempt conciliation of the dispute. The EEOC has filed a number of lawsuits to prove statistically that a company has systematically discriminated on one of the forbidden bases. The EEOC has received perennial criticism for its extreme slowness in filing suits and for failure to handle the huge backlog of complaints with which it has had to wrestle.

The courts have come to recognize two major types of Title VII cases:

1. Cases of disparate treatment
    - In this type of lawsuit, the plaintiff asserts that because of race, sex, religion, or national origin, he or she has been treated less favorably than others within the organization. To prevail in a disparate treatment suit, the plaintiff must show that the company *intended* to discriminate because of one of the factors the law forbids to be considered. Thus in *McDonnell Douglas Corp. v. Green*, the Supreme Court held that the plaintiff had shown that the company intended to discriminate by refusing to rehire him because of his race.*McDonnell Douglas Corp. v. Green*, 411 U.S. 792 (1973). In general, there are two types of disparate treatment cases: (1) pattern-and-practice cases, in which the employee asserts that the employer systematically discriminates on the grounds of race, religion, sex, or national origin; and (2) reprisal or retaliation cases, in which the employee must show that the employer discriminated against him or her because that employee asserted his or her Title VII rights.
2. Cases of disparate impact
    - In this second type of Title VII case, the employee need not show that the employer intended to discriminate but only that the effect, or impact, of the employer's action was discriminatory. Usually, this impact will be upon an entire class of employees. The plaintiff must demonstrate that the reason for the employer's conduct (such as refusal to promote) was not job related. Disparate impact cases often arise out of practices that appear to be neutral or nondiscriminatory on the surface, such as educational requirements and tests administered to help the employer choose the most qualified candidate. In the seminal case of *Griggs v. Duke Power Co.*, the Supreme Court held that under Title VII, an employer is not free to use any test it pleases; the test must bear a genuine relationship to job performance.*Griggs v. Duke Power Co.*, 401 U.S. 424 (1971).*Griggs* stands for the proposition that Title VII "prohibits employment practices that have discriminatory effects as well as those that are intended to discriminate."



Figure 16.1 A Checklist of Employment Law

Discrimination Based on Religion

An employer who systematically refuses to hire Catholics, Jews, Buddhists, or members of any other religious group engages in unlawful disparate treatment under Title VII. But refusal to deal with someone because of his or her religion is not the only type of violation under the law. Title VII defines religion as including religious observances and practices as well as belief and requires the employer to "reasonably accommodate to an employee's or prospective employee's religious observance or practice" unless the employer can demonstrate that a reasonable accommodation would work an "undue hardship on the conduct of the employer's business." Thus a company that refused even to consider permitting a devout Sikh to wear his religiously prescribed turban on the job would violate Title VII.

But the company need not make an accommodation that would impose more than a minimal cost. For example, an employee in an airline maintenance department, open twenty-four hours a day, wished to avoid working on his Sabbath. The employee belonged to a union, and under the collective bargaining agreement, a rotation system determined by seniority would have put the worker into a work shift that fell on his Sabbath. The Supreme Court held that the employer was not required to pay premium wages to someone whom the seniority system would not require to work on that day and could discharge the employee if he refused the assignment.*Trans World Airlines v. Hardison*, 432 U.S. 63 (1977).

Title VII permits religious organizations to give preference in employment to individuals of the same religion. Obviously, a synagogue looking for a spiritual leader would hire a rabbi and not a priest.

Sex Discrimination

A refusal to hire or promote a woman simply because she is female is a clear violation of Title VII. Under the Pregnancy Act of 1978, Congress declared that discrimination because of pregnancy is a form of sex discrimination. Equal pay for equal or comparable work has also been an issue in sex discrimination. *Barbano v. Madison County* (see Section 16.4.1 "Disparate Treatment: Burdens of Proof"), presents a straightforward case of sex discrimination. In that case, notice how the plaintiff has the initial burden of proving discriminatory intent and how the burden then shifts to the defendant to show a plausible, nondiscriminatory reason for its hiring decision.

The late 1970s brought another problem of sex discrimination to the fore: sexual harassment. There is much fear and ignorance about sexual harassment among both employers and employees. Many men think they cannot compliment a woman on her appearance without risking at least a warning by the human resources department. Many employers have spent significant time and money trying to train employees about sexual harassment, so as to avoid lawsuits. Put simply, sexual harassment involves unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature.

There are two major categories of sexual harassment: (1) quid pro quo and (2) hostile work environment.

Quid pro quo comes from the Latin phrase "one thing in return for another." If any part of a job is made conditional on sexual activity, there is quid pro quo sexual harassment. Here, one person's power over another is essential; a coworker, for example, is not usually in a position to make sexual demands on someone at his same level, unless he has special influence with a supervisor who has power to hire, fire, promote, or change work assignments. A supervisor, on the other hand, typically has those powers or the power to influence those kinds of changes. For example, when the male foreman says to the female line worker, "I can get you off of the night shift if you'll sleep with me," there is quid pro quo sexual harassment.

In *Harris v. Forklift Systems, Inc.Harris v. Forklift Systems, Inc.*, 510 U.S. 17 (1993) and in *Meritor v. Vinson,Meritor v. Vinson*, 477 U.S. 57 (1986) we see examples of hostile work environment. Hostile work environment claims are more frequent than quid pro quo claims and so are more worrisome to management. An employee has a valid claim of sexual harassment if sexual talk, imagery, or behavior becomes so pervasive that it interferes with the employee's ability to work to her best capacity. On occasion, courts have found that offensive jokes, if sufficiently frequent and pervasive in the workplace, can create a hostile work environment. Likewise, comments about body parts or public displays of pornographic pictures can also create a hostile work environment. In short, the plaintiff can be detrimentally offended and hindered in the workplace even if there are no measurable psychological injuries.

In the landmark hostile work environment case of *Meritor v. Vinson*, the Supreme Court held that Title VII's ban on sexual harassment encompasses more than the trading of sexual favors for employment benefits. Unlawful sexual harassment also

includes the creation of a hostile or offensive working environment, subjecting both the offending employee and the company to damage suits even if the victim was in no danger of being fired or of losing a promotion or raise.

In recalling *Harris v. Forklift Systems* (Chapter 1, Section 1.6), we see that the "reasonable person" standard is declared by the court as follows: "So long as the environment would reasonably be perceived, and is perceived, as hostile or abusive there is no need for it also to be psychologically injurious." In *Duncan v. General Motors Corporation* (see Section 16.4.2 "Title VII and Hostile Work Environment"), *Harris* is used as a precedent to deny relief to a woman who was sexually harassed, because the court believed the conditions were not severe or pervasive enough to unreasonably interfere with her work.

California, under FEHA, uses a more liberal standard than the federal "severe and pervasive" test for an actionable sexual harassment claim based on a hostile work environment. A California plaintiff seeking relief under FEHA must show the sexual harassment, "would have interfered with a reasonable employee's work performance and would have seriously affected the psychological well-being of a reasonable employee." (*Miller v. Department of Corrections*, 36 Cal.4th 446 (2005).) FEHA provides additional protections against gender-based and other discrimination not found in federal law, such as prohibitions on discrimination based on gender identity, sexual orientation, and pregnancy.

Discrimination Based on Race, Color, and National Origin

Title VII was primarily enacted to prohibit employment discrimination based on race, color, and national origin. Race refers to broad categories such as black, Caucasian, Asian, and Native American. Color simply refers to the color of a person's skin, and national origin refers to the country of the person's ancestry.

Exceptions to Title VII

Merit

Employers are allowed to select on merit and promote on merit without offending title VII's requirements. Merit decisions are usually based on work, educational experience, and ability tests. All requirements, however, must be job related. For example, the ability to lift heavy cartons of sixty pounds or more is appropriate for certain warehouse jobs but is not appropriate for all office workers. The ability to do routine maintenance (electrical, plumbing, construction) is an appropriate requirement for maintenance work but not for a teaching position. Requiring someone to have a high school degree, as in *Griggs vs. Duke Power Co.*, is not appropriate as a qualification for common labor.

Seniority

Employers may also maintain seniority systems that reward workers who have been with the company for a long time. Higher wages, benefits, and choice of working hours or vacation schedules are examples of rewards that provide employees with an incentive to stay with the company. If they are not the result of intentional discrimination, they are lawful. Where an employer is dealing with a union, it is typical to see seniority systems in place.

Bona Fide Occupational Qualification (BFOQ)

For certain kinds of jobs, employers may impose bona fide occupational qualifications (BFOQs). Under the express terms of Title VII, however, a bona fide (good faith) occupational qualification of race or color is never allowed. In the area of religion, as noted earlier, a group of a certain religious faith that is searching for a new spiritual leader can certainly limit its search to those of the same religion. One important test that the courts employ in evaluating an employer's BFOQ claims is the "essence of the business" test.

In *Diaz v. Pan American World Airways, Inc.*, the airline maintained a policy of exclusively hiring females for its flight attendant positions. (*Diaz v. Pan American World Airways, Inc.*, 442 F.2d 385 (5th Cir. 1971).) The essence of the business test was established with the court's finding that "discrimination based on sex is valid only when the essence of the business operation would be undermined by not hiring members of one sex exclusively." Although the court acknowledged that females might be better suited to fulfill the required duties of the position, this was not enough to fulfill the essence of the business test:

The primary function of an airline is to transport passengers safely from one point to another. While a pleasant environment, enhanced by the obvious cosmetic effect that female stewardesses provide as well as…their apparent ability to perform the non-mechanical functions of the job in a more effective manner than most men, may all be important, they are tangential to the essence

of the business involved. No one has suggested that having male stewards will so seriously affect the operation of an airline as to jeopardize or even minimize its ability to provide safe transportation from one place to another. (*Diaz v. Pan American World Airways, Inc.*, 442 F.2d 385 (5th Cir. 1971).)

The reason that airlines now use the gender-neutral term *flight attendant* is a direct result of Title VII. In the 1990s, Hooters had some difficulty convincing the EEOC and certain male plaintiffs that only women could be hired as waitstaff in its restaurants. Its matter resulted in a settlement with the EEOC, where the company agreed to pay a fine and introduce gender-neutral hiring criteria for non-server, "front of house" roles. In 2025, the Department of Homeland Security successfully argued that it could assign three female-only night shifts was reasonably necessary to ensure that female officers would be available to conduct and observe personal searches of female travelers. (*Anderson v. Mayorkas*, No. 8:22-cv-2941-VMC-CPT (2025).)

Defenses in Sexual Harassment Cases

In the 1977 term, the US Supreme Court issued two decisions that provide an affirmative defense in some sexual harassment cases. In *Faragher v. City of Boca RatonFaragher v. City of Boca Raton*, 524 U.S. 775 (1998). and in *Burlington Industries, Inc. v. Ellerth,Burlington Industries v. Ellerth*, 524 U.S. 742 (1988). female employees sued for sexual harassment. In each case, they proved that their supervisors had engaged in unconsented-to touching as well as verbal sexual harassment. In both cases, the plaintiff quit her job and, after going through the EEOC process, got a right-to-sue letter and in fact sued for sexual harassment. In *Faragher*, the employer had never disseminated the policy against sexual harassment to its employees. But in the second case, *Burlington Industries*, the employer had a policy that was made known to employees. Moreover, a complaints system had been established that was not used by the female employee.

Both opinions rejected the notion of strict or automatic liability for employers when agents (employees) engage in sexual harassment. But the employer can have a valid defense to liability if it can prove (1) that it exercised reasonable care to prevent and correct any sexual harassment behaviors and (2) that the plaintiff employee unreasonably failed to take advantage of any preventive or corrective opportunities provided by the employer or to otherwise avoid harm. As with all affirmative defenses, the employer has the burden of proving this defense.

Affirmative Action

Affirmative action is mentioned in the statutory language of Title VII, as courts have the power to order affirmative action as a remedy for the effects of past discriminatory actions. In addition to court-ordered affirmative action, employers may voluntarily use an affirmative action plan to remedy the effects of past practices or to achieve diversity within the workforce to reflect the diversity in their community. In *Johnson v. Santa Clara County Transportation Agency*, 480 U.S. 616 (1987). the agency had an affirmative action plan. A woman was promoted from within to the position of dispatcher, even though a male candidate had a slightly higher score on a test that was designed to measure aptitude for the job. The man brought a lawsuit alleging sex discrimination. The Court found that voluntary affirmative action was not reverse discrimination in this case, but employers should be careful in hiring and firing and layoff decisions versus promotion decisions. It is in the area of promotions that affirmative action is more likely to be upheld.

In government contracts, President Lyndon Johnson's Executive Order 11246 prohibits private discrimination by federal contractors. This is important, because one-third of all US workers are employed by companies that do business with the federal government. Because of this executive order, many companies that do business with the government have adopted voluntary affirmative action programs. In 1995, the Supreme Court limited the extent to which the government could require contractors to establish affirmative action programs. The Court said that such programs are permissible only if they serve a "compelling national interest" and are "narrowly tailored" so that they minimize the harm to white males. To make a requirement for contractors, the government must show that the programs are needed to remedy past discrimination, that the programs have time limits, and that nondiscriminatory alternatives are not available. (*Adarand Constructors, Inc. v. Pena*, 515 U.S. 200 (1995).)

The Age Discrimination in Employment Act

The Age Discrimination in Employment Act (ADEA) of 1967 (amended in 1978 and again in 1986) prohibits discrimination based on age, and recourse to this law has been growing at a faster rate than any other federal antibias employment law. In particular, the act protects workers over forty years of age and prohibits forced retirement in most jobs because of age. Until 1987, federal law had

permitted mandatory retirement at age seventy, but the 1986 amendments that took effect January 1, 1987, abolished the age ceiling except for a few jobs, such as firefighters, police officers, tenured university professors, and executives with annual pensions exceeding $44,000. Like Title VII, the law has a BFOQ exception—for example, employers may set reasonable age limitations on certain high-stress jobs requiring peak physical condition.

There are important differences between the ADEA and Title VII, as *Gross v. FBL Financial Services, Inc.* (Section 16.4.3 "Age Discrimination: Burden of Persuasion") makes clear. It is now more difficult to prove an age discrimination claim than a claim under Title VII.

Americans with Disabilities Act (ADA)

The 1990 Americans with Disabilities Act (ADA) prohibits employers from discriminating on the basis of disability. A disabled person is someone with a physical or mental impairment that substantially limits a major life activity or someone who is regarded as having such an impairment. This definition includes people with mental illness, epilepsy, visual impairment, dyslexia, and AIDS. It also covers anyone who has recovered from alcoholism or drug addiction. It specifically does not cover people with sexual disorders, pyromania, kleptomania, exhibitionism, or compulsive gambling.

Employers cannot disqualify an employee or job applicant because of disability as long as he or she can perform the essential functions of the job, with reasonable accommodation. Reasonable accommodation might include installing ramps for a wheelchair, establishing more flexible working hours, creating or modifying job assignments, and the like.

Reasonable accommodation means that there is no undue hardship for the employer. The law does not offer uniform standards for identifying what may be an undue hardship other than the imposition on the employer of a "significant difficulty or expense." Cases will differ: the resources and situation of each particular employer relative to the cost or difficulty of providing the accommodation will be considered; relative cost, rather than some definite dollar amount, will be the issue.

As with other areas of employment discrimination, job interviewers cannot ask questions about an applicant's disabilities before making a job offer; the interviewer may only ask whether the applicant can perform the work. Requirements for a medical exam are a violation of the ADA unless the exam is job related and required of all applicants for similar jobs. Employers may, however, use drug testing, although public employers are to some extent limited by the Fourth Amendment requirements of reasonableness.

The ADA's definition of disability is very broad. However, the Supreme Court has issued several important decisions that narrow the definition of what constitutes a disability under the act.

Two kinds of narrowing decisions stand out: one deals with "correctable conditions," and the other deals with repetitive stress injuries. In 1999, the Supreme Court reviewed a case that raised an issue of whether severe nearsightedness (which can be corrected with lenses) qualifies as a disability under the ADA.*Sutton v. United Airlines, Inc.*, 527 U.S. 471 (1999). The Supreme Court ruled that disability under the ADA will be measured according to how a person functions with corrective drugs or devices and not how the person functions without them. In *Orr v. Wal-Mart Stores, Inc.*, a federal appellate court held that a pharmacist who suffered from diabetes did not have a cause of action against Wal-Mart under the ADA as long as the condition could be corrected by insulin. (*Orr v. Wal-Mart Stores, Inc.*, 297 F.3d 720 (8th Cir. 2002).)

The other narrowing decision deals with repetitive stress injuries. For example, carpal tunnel syndrome—or any other repetitive stress injury—could constitute a disability under the ADA. By compressing a nerve in the wrist through repetitive use, carpal tunnel syndrome causes pain and weakness in the hand. In 2002, the Supreme Court determined that while an employee with carpal tunnel syndrome could not perform all the manual tasks assigned to her, her condition did not constitute a disability under the ADA because it did not "extensively limit" her major life activities.

In 2025, the US Supreme Court held the ADA only applies to current employees and applicants, not retirees. (*Stanley v. City of Sanford*, 606 U.S. ___ (2025).) Thus, a retiree cannot successfully sue a former employer under the ADA on the grounds that changes to post-retirement benefits are discriminatory.

Equal Pay Act

The Equal Pay Act of 1963 protects both men and women from pay discrimination based on sex. The act covers all levels of private sector employees and state and local government employees but not federal workers. The act prohibits disparity in pay for jobs that require equal skill and equal effort. Equal skill means equal experience, and equal effort means comparable mental and/or physical

exertion. The act prohibits disparity in pay for jobs that require equal responsibility, such as equal supervision and accountability, or similar working conditions.

In making their determinations, courts will look at the stated requirements of a job as well as the actual requirements of the job. If two jobs are judged to be equal and similar, the employer cannot pay disparate wages to members of different sexes. Along with the EEOC enforcement, employees can also bring private causes of action against an employer for violating this act. There are four criteria that can be used as defenses in justifying differentials in wages: seniority, merit, quantity or quality of product, and any factor other than sex. The employer will bear the burden of proving any of these defenses.

A defense based on merit will require that there is some clearly measurable standard that justifies the differential. In terms of quantity or quality of product, there may be a commission structure, piecework structure, or quality-control-based payment system that will be permitted. Factors "other than sex" do not include so-called market forces. In *Glenn v. General Motors Corp.*, the US Court of Appeals for the Eleventh Circuit rejected General Motor's argument that it was justified in paying three women less than their male counterparts on the basis of "the market force theory" that women will work for less than a man. (*Glenn v. General Motors Corp.*, 841 F.2d 1567 (1988).)

Key Takeaway

Starting with employment at will as a common-law doctrine, we see many modifications by statute, particularly after 1960. Title VII of the Civil Rights Act of 1964 is the most significant, for it prohibits employers engaged in interstate commerce from discriminating on the basis of race, color, sex, religion, or national origin.

Sex discrimination, especially sexual harassment, has been a particularly fertile source of litigation. There are many defenses to Title VII claims: the employer may have a merit system or a seniority system in place, or there may be bona fide occupational qualifications in religion, gender, or national origin. In addition to Title VII, federal statutes limiting employment discrimination are the ADEA, the ADA, and the Equal Pay Act.

Exercises

1. Go to the EEOC website. Describe the process by which an employee or ex-employee who wants to make a Title VII claim obtains a right-to-sue letter from the EEOC.
2. Again, looking at the EEOC website, find the statistical analysis of Title VII claims brought to the EEOC. What kind of discrimination is most frequent?
3. According to the EEOC website, what is "retaliation"? How frequent are retaliation claims relative to other kinds of claims?
4. Greg Connolly is a member of the Church of God and believes that premarital sex and abortion are sinful. He works as a pharmacist for Wal-Mart, and at many times during the week, he is the only pharmacist available to fill prescriptions. One product sold at his Wal-Mart is the morning-after pill (RU 468). Based on his religious beliefs, he tells his employer that he will refuse to fill prescriptions for the morning-after pill. Must Wal-Mart make a reasonable accommodation to his religious beliefs?

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11.3: Employment at Will

Learning Objectives

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

- Understand what is meant by employment at will under common law.
- Explain the kinds of common-law (judicially created) exceptions to the employment-at-will doctrine, and provide examples.

At common law, an employee without a contract guaranteeing a job for a specific period was an **employee at will** and could be fired at any time and for any reason, or even for no reason at all. The various federal statutes we have just examined have made inroads on the at-will doctrine. Another federal statute, the Occupational Safety and Health Act, prohibits employers from discharging employees who exercise their rights under that law.

The courts and legislatures in more than forty states have made revolutionary changes in the at-will doctrine. They have done so under three theories: tort, contract, and duty of good faith and fair dealing. We will first consider the tort of wrongful discharge.

Courts have created a major exception to the employment-at-will rule by allowing the tort of wrongful discharge. *Wrongful discharge* means firing a worker for a bad reason. What is a bad reason? A bad reason can be:

1. discharging an employee for refusing to violate a law,
2. discharging an employee for exercising a legal right,
3. discharging an employee for performing a legal duty, and
4. discharging an employee in a way that violates public policy.

Discharging an Employee for Refusing to Violate a Law

Some employers will not want employees to testify truthfully at trial. In one case, a nurse refused a doctor's order to administer a certain anesthetic when she believed it was wrong for that particular patient; the doctor, angry at the nurse for refusing to obey him, then administered the anesthetic himself. The patient soon stopped breathing. The doctor and others could not resuscitate him soon enough, and he suffered permanent brain damage. When the patient's family sued the hospital, the hospital told the nurse she would be in trouble if she testified. She did testify according to her oath in the court of law (i.e., truthfully), and after several months of harassment, was finally fired on a pretext. The hospital was held liable for the tort of wrongful discharge. As a general rule, you should not fire an employee for refusing to break the law.

Discharging an Employee for Exercising a Legal Right

Suppose Bob Berkowitz files a claim for workers' compensation for an accident at Pacific Gas & Electric, where he works and where the accident that injured him took place. He is fired for doing so, because the employer does not want to have its workers' comp premiums increased. In this case, the right exercised by Berkowitz is supported by public policy: he has a legal right to file the claim, and if he can establish that his discharge was caused by his filing the claim, he will prove the tort of wrongful discharge.

Discharging an Employee for Performing a Legal Duty

Courts have long held that an employee may not be fired for serving on a jury. This is so even though courts do recognize that many employers have difficulty replacing employees called for jury duty. Jury duty is an important civic obligation, and employers are not permitted to undermine it.

Discharging an Employee in a Way That Violates Public Policy

This is probably the most controversial basis for a tort of wrongful discharge. There is an inherent vagueness in the phrase "basic social rights, duties, or responsibilities." This is similar to the exception in contract law: the courts will not enforce contract provisions that violate public policy. (For the most part, public policy is found in statutes and in cases.) But what constitutes public policy is an important decision for state courts. In *Wagenseller v. Scottsdale Memorial Hospital*, 147 Ariz. 370; 710 P.2d 1025 (1985), for example, a nurse who refused to "play along" with her coworkers on a rafting trip was discharged. The group of

coworkers had socialized at night, drinking alcohol; when the partying was near its peak, the plaintiff refused to be part of a group that bared their buttocks to the tune of “Moon River” (a composition by Henry Mancini that was popular in the 1970s). The court, at great length, considered that “mooning” was a misdemeanor under Arizona law and that therefore her employer could not discharge her for refusing to violate a state law.

Other courts have gone so far as to include professional oaths and codes as part of public policy. In *Rocky Mountain Hospital and Medical Services v. Diane Mariani*, the Colorado Supreme Court reviewed a trial court decision to refuse relief to a certified public accountant who was discharged when she refused to violate her professional code. (*Rocky Mountain Hospital and Medical Services v. Diane Mariani*, 916 P.2d 519 (Colo. 1996).) Her employer had repeatedly required her to come up with numbers and results that did not reflect the true situation, using processes that were not in accord with her training and the code. According to the court, the fact that employee's employer asked her to knowingly misrepresent facts was a sufficient basis in public policy to make her discharge wrongful.

Contract Modification of Employment at Will

Contract law can modify employment at will. Oral promises made in the hiring process may be enforceable even though the promises are not approved by top management. Employee handbooks may create implied contracts that specify personnel processes and statements that the employees can be fired only for a “just cause” or only after various warnings, notice, hearing, or other procedures.

Good Faith and Fair Dealing Standard

A few states, among them Massachusetts and California, have modified the at-will doctrine in a far-reaching way by holding that every employer has entered into an implied covenant of good faith and fair dealing with its employees. That means, the courts in these states say, that it is “bad faith” and therefore unlawful to discharge employees to avoid paying commissions or pensions due them. Under this implied covenant of fair dealing, any discharge without good cause—such as incompetence, corruption, or habitual tardiness—is actionable if done to avoid paying an employee what he or she is due.

Key Takeaway

Although employment at will is still the law, numerous exceptions have been established by judicial decision. Employers can be liable for the tort of wrongful discharge if they discharge an employee for refusing to violate a law, for exercising a legal right or performing a legal duty, or in a way that violates basic public policy.

Exercises

1. Richard Mudd, an employee of ZQSE, is called for jury duty in Wayne County, Michigan. His immediate supervisor, Harvey Lorie, lets him know that he “must” avoid jury duty at all costs. Mudd tells the judge of his circumstances and his need to be at work, but the judge refuses to let Mudd avoid jury duty. Mudd spends the next two weeks at trial. He sends regular e-mails and texts to Lorie during this time, but on the fourth day gets a text message from Lorie that says, “Don’t bother to come back.” When he does return, Lorie tells him he is fired. Does Mudd have a cause of action for the tort of wrongful discharge?
2. Olga Monge was a schoolteacher in her native Costa Rica. She moved to New Hampshire and attended college in the evenings to earn US teaching credentials. At night, she worked at the Beebe Rubber Company after caring for her husband and three children during the day. When she applied for a better job at the plant, the foreman offered to promote her if she would be “nice” and go out on a date with him. She refused, and he assigned her to a lower-wage job, took away her overtime, made her clean the washrooms, and generally ridiculed her. She finally collapsed at work, and he fired her. Does Monge have any cause of action?

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11.4: Other Employment-Related Laws

Learning Objectives

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

- Understand the various federal and state statutes that affect employers in the areas of plant closings, pensions, workers' compensation, use of polygraphs, and worker safety.

The Federal Plant-Closing Act

A prime source of new jobs across the United States is the opening of new industrial plants—which accounted for millions of jobs a year during the 1970s and 1980s. But for every 110 jobs thus created, nearly 100 were lost annually in plant closings during that period. In the mid-1980s alone, 2.2 million plant jobs were lost each year. As serious as those losses were for the national economy, they were no less serious for the individuals who were let go. Surveys in the 1980s showed that large numbers of companies provided little or no notice to employees that their factories were to be shut down and their jobs eliminated. Nearly a quarter of businesses with more than 100 employees provided no specific notice to their employees that their particular work site would be closed or that they would suffer mass layoffs. More than half provided two weeks' notice or less.

Because programs to support dislocated workers depend heavily on the giving of advance notice, a national debate on the issue in the late 1980s culminated in 1988 in Congress's enactment of the Worker Adjustment and Retraining Notification (WARN) Act, the formal name of the federal plant-closing act. Under this law, businesses with 100 or more employees must give employees or their local bargaining unit, along with the local city or county government, at least sixty days' notice whenever (1) at least 50 employees in a single plant or office facility would lose their jobs or face long-term layoffs or a reduction of more than half their working hours as the result of a shutdown and (2) a shutdown would require long-term layoffs of 500 employees or at least a third of the workforce. An employer who violates the act is liable to employees for back pay that they would have received during the notice period and may be liable to other fines and penalties.

An employer is exempted from having to give notice if the closing is caused by business circumstances that were not reasonably foreseeable as of the time the notice would have been required. An employer is also exempted if the business is actively seeking capital or business that if obtained, would avoid or postpone the shutdown and the employer, in good faith, believes that giving notice would preclude the business from obtaining the needed capital or business.

The Employee Polygraph Protection Act

Studies calling into question the reliability of various forms of lie detectors have led at least half the states and, in 1988, Congress to legislate against their use by private businesses. The Employee Polygraph Protection Act forbids private employers from using lie detectors (including such devices as voice stress analyzers) for any reason. Neither employees nor applicants for jobs may be required or even asked to submit to them. (The act has some exceptions for public employers, defense and intelligence businesses, private companies in the security business, and manufacturers of controlled substances.)

Use of polygraphs, machines that record changes in the subject's blood pressure, pulse, and other physiological phenomena, is strictly limited. They may be used in conjunction with an investigation into such crimes as theft, embezzlement, and industrial espionage, but in order to require the employee to submit to polygraph testing, the employer must have "reasonable suspicion" that the employee is involved in the crime, and there must be supporting evidence for the employer to discipline or discharge the employee either on the basis of the polygraph results or on the employee's refusal to submit to testing. The federal polygraph law does not preempt state laws, so if a state law absolutely bars an employer from using one, the federal law's limited authorization will be unavailable.

Occupational Safety and Health Act

In a heavily industrialized society, workplace safety is a major concern. Hundreds of studies for more than a century have documented the gruesome toll taken by hazardous working conditions in mines, on railroads, and in factories from tools, machines, treacherous surroundings, and toxic chemicals and other substances. Studies in the late 1960s showed that more than 14,000 workers were killed and 2.2 million were disabled annually—at a cost of more than $8 billion and a loss of more than 250 million

worker days. Congress responded in 1970 with the Occupational Safety and Health Act, the primary aim of which is "to assure so far as possible every working man and woman in the Nation safe and healthful working conditions."

The act imposes on each employer a general duty to furnish a place of employment free from recognized hazards likely to cause death or serious physical harm to employees. It also gives the secretary of labor the power to establish national health and safety standards. The standard-making power has been delegated to the Occupational Safety and Health Administration (OSHA), an agency within the US Department of Labor. The agency has the authority to inspect workplaces covered by the act whenever it receives complaints from employees or reports about fatal or multiple injuries. The agency may assess penalties and proceed administratively to enforce its standards. Criminal provisions of the act are enforced by the Justice Department.

During its first two decades, OSHA was criticized for not issuing standards very quickly: fewer than thirty national workplace safety standards were issued by 1990. But not all safety enforcement is in the hands of the federal government: although OSHA standards preempt similar state standards, under the act the secretary may permit the states to come up with standards equal to or better than federal standards and may make grants to the states to cover half the costs of enforcement of the state safety standards.

Employee Retirement Income Security Act

More than half the US workforce is covered by private pension plans for retirement. One 2025 estimate put the total held in pension funds at more than $9.8 *trillion*, costing the federal Treasury nearly $136 billion annually in tax write-offs. As the size of the private pension funds increased dramatically in the 1960s, Congress began to hear shocking stories of employees defrauded out of pension benefits, deprived of a lifetime's savings through various ruses (e.g., by long vesting provisions and by discharges just before retirement). To put an end to such abuses, Congress, in 1974, enacted the Employee Retirement Income Security Act (ERISA).

In general, ERISA governs the vesting of employees' pension rights and the funding of pension plans. Within five years of beginning employment, employees are entitled to vested interests in retirement benefits contributed on their behalf by individual employers. Multi-employer pension plans must vest their employees' interests within ten years. A variety of pension plans must be insured through a federal agency, the Pension Benefit Guaranty Corporation, to which employers must pay annual premiums. The corporation may assume financial control of underfunded plans and may sue to require employers to make up deficiencies. The act also requires pension funds to disclose financial information to beneficiaries, permits employees to sue for benefits, governs the standards of conduct of fund administrators, and forbids employers from denying employees their rights to pensions. The act largely preempts state law governing employee benefits.

Fair Labor Standards Act

In the midst of the Depression, Congress enacted at President Roosevelt's urging a national minimum wage law, the Fair Labor Standards Act of 1938 (FLSA). The act prohibits most forms of child labor and established a scale of minimum wages for the regular workweek and a higher scale for overtime. (The original hourly minimum was twenty-five cents, although the administrator of the Wage and Hour Division of the US Department of Labor, a position created by the act, could raise the minimum rate industry by industry.) The act originally was limited to certain types of work: that which was performed in transporting goods in interstate commerce or in producing goods for shipment in interstate commerce.

Employers quickly learned that they could limit the minimum wage by, for example, separating the interstate and intrastate components of their production. Within the next quarter century, the scope of the FLSA was considerably broadened, so that it now covers all workers in businesses that do a particular dollar-volume of goods that move in interstate commerce, regardless of whether a particular employee actually works in the interstate component of the business. It now covers between 80 and 90 percent of all persons privately employed outside of agriculture, and a lesser but substantial percentage of agricultural workers and state and local government employees. Violations of the act are investigated by the administrator of the Wage and Hour Division, who has authority to negotiate back pay on the employee's behalf. If no settlement is reached, the Labor Department may sue on the employee's behalf, or the employee, armed with a notice of the administrator's calculations of back wages due, may sue in federal or state court for back pay. Under the FLSA, a successful employee will receive double the amount of back wages due.

Workers' Compensation Laws

Since the beginning of the twentieth century, work-related injuries or illnesses have been covered under state workers' compensation laws that provide a set amount of weekly compensation for disabilities caused by accidents and illnesses suffered on the job. The compensation plans also pay hospital and medical expenses necessary to treat workers who are injured by, or become ill from, their work. In assuring workers of compensation, the plans eliminate the hazards and uncertainties of lawsuits by eliminating the need to prove fault. Conceptually, the system reduces employer costs and litigation. Employers fund the compensation plans by paying into statewide plans or purchasing insurance.

Other State Laws

Although it may appear that most employment law is federal, employment discrimination is largely governed by state law because Congress has so declared it. The Civil Rights Act of 1964 tells federal courts to defer to state agencies to enforce anti-discrimination provisions of parallel state statutes with remedies similar to those of the federal law. Moreover, many states have gone beyond federal law in banning certain forms of discrimination. Thus well before enactment of the Americans with Disabilities Act, more than forty states prohibited such discrimination in private employment. More than a dozen states ban employment discrimination based on marital status, a category not covered by federal law. Two states have laws that protect those that may be considered "overweight." Many states and municipalities ban employment discrimination on the basis of sexual orientation; most large companies have offices or plants in at least one of these jurisdictions. By contrast, federal law has no statutory law dealing with sexual orientation.

Key Takeaway

There are a number of important federal employment laws collective bargaining or discrimination. These include the federal plant-closing act, the Employee Polygraph Protection Act, the Occupational Safety and Health Act, the Employee Retirement Income Security Act, and the Fair Labor Standards Act. At the state level, workers' compensation laws preempt common-law claims against employers for work-related injuries, and state equal opportunity employment laws provide remedies for certain kinds of workplace discrimination that have no parallel at the federal level.

Exercises

1. United Artists is a corporation doing business in Texas. United Pension Fund is a defined-contribution employee pension benefit plan sponsored by United Artists for employees. Each employee has his or her own individual pension account, but plan assets are pooled for investment purposes. The plan is administered by the board of trustees. From 1977 to 1986, seven of the trustees made a series of loans to themselves from the plan. These trustees did not (1) require the borrowers to submit a written application for the loans, (2) assess the prospective borrower's ability to repay loans, (3) specify a period in which the loans were to be repaid, or (4) call the loans when they remained unpaid. The trustees also charged less than fair-market-value interest for the loans. The secretary of labor sued the trustees, alleging that they had breached their fiduciary duty in violation of ERISA. Who won? (*Mc Laughlin v. Rowley*, 69 F.Supp. 1333 (N.D. Tex. 1988).)
2. Arrow Automotive Industries remanufactures and distributes automobile and truck parts. Its operating plants produce identical product lines. The company is planning to open a new facility in Santa Maria, California. The employees at the Arrow plant in Hudson, Massachusetts, are represented by a union, the United Automobile, Aerospace, and Agricultural Implement Workers of America. The Hudson plant has a history of unprofitable operations. The union called a strike when the existing collective bargaining agreement expired and a new agreement could not be reached. After several months, the board of directors of the company voted to close the striking plant. The closing would give Arrow a 24 percent increase in gross profits and free capital and equipment for the new Santa Maria plant. In addition, the existing customers of the Hudson plant could be serviced by the Spartanburg, South Carolina, plant, which is currently being underutilized. What would have to be done if the plant-closing act applied to the situation? (*Arrow Automotive Industries, Inc. v. NLRB*, 853 F.2d 233 (4th Cir. 1989).)

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11.5: Summary and Exercises

Summary

For the past sixty years, Title VII of the Civil Rights Act of 1964 has prohibited employment discrimination based on race, religion, sex, or national origin. Any employment decision, including hiring, promotion, and discharge, based on one of these factors is unlawful and subjects the employer to an award of back pay, promotion, or reinstatement. The Equal Employment Opportunity Commission (EEOC) may file suits, as may the employee—after the commission screens the complaint.

Two major types of discrimination suits are those for disparate treatment (in which the employer intended to discriminate) and disparate impact (in which, regardless of intent, the impact of a particular non-job-related practice has a discriminatory effect). In matters of religion, the employer is bound not only to refrain from discrimination based on an employee's religious beliefs or preferences but also to accommodate the employee's religious practices to the extent that the accommodation does not impose an undue hardship on the business.

Sex discrimination, besides refusal to hire a person solely on the basis of sex, includes discrimination based on pregnancy. Sexual harassment is a form of sex discrimination, and it includes the creation of a hostile or offensive working environment. A separate statute, the Equal Pay Act, mandates equal pay for men and women assigned to the same job.

One major exception to Title VII permits hiring people of a particular religion, sex, or nationality if that feature is a bona fide occupational qualification. There is no bona fide occupational qualification (BFOQ) exception for race, nor is a public stereotype a legitimate basis for a BFOQ.

Affirmative action plans, permitting or requiring employers to hire on the basis of race to make up for past discrimination or to bring up the level of minority workers, have been approved, even though the plans may seem to conflict with Title VII. But affirmative action plans have not been permitted to overcome bona fide seniority or merit systems.

The Age Discrimination in Employment Act protects workers over forty from discharge solely on the basis of age. Amendments to the law have abolished the age ceiling for retirement, so that most people working for employers covered by the law cannot be forced to retire.

The Americans with Disabilities Act of 1990 prohibits discrimination based on disability and applies to most jobs in the private sector.

At common law, an employer was free to fire an employee for any reason or for no reason at all. In recent years, the employment-at-will doctrine has been seriously eroded. Many state courts have found against employers on the basis of implied contracts, tortious violation of public policy, or violations of an implied covenant of good faith and fair dealing.

Beyond antidiscrimination law, several other statutes have an impact on the employment relationship. These include the plant-closing law, the Employee Polygraph Protection Act, the Occupational Safety and Health Act, the Employee Retirement Income Security Act, and the Fair Labor Standards Act.

Exercises

1. Rainbow Airlines, a new air carrier headquartered in Chicago with routes from Rome to Canberra, extensively studied the psychology of passengers and determined that more than 93 percent of its passengers felt most comfortable with female flight attendants between the ages of twenty-one and thirty-four. To increase its profitability, the company issued a policy of hiring only such people for jobs in the air but opened all ground jobs to anyone who could otherwise qualify. The policy made no racial distinction, and, in fact, nearly 30 percent of the flight attendants hired were black. What violations of federal law has Rainbow committed, if any?
2. Tex Olafson worked for five years as a messenger for Pressure Sell Advertising Agency, a company without a unionized workforce. On his fifth anniversary with the company, Tex was called in to the president's office, was given a 10 percent raise, and was complimented on his diligence. The following week, a new head of the messenger department was hired. He wanted to appoint his nephew to a messenger job but discovered that a company-wide hiring freeze prevented him from adding another employee to the messenger ranks. So he fired Tex and hired his nephew. What remedy, if any, does Tex have? What additional facts might change the result?

3. Ernest lost both his legs in combat in Vietnam. He has applied for a job with Excelsior Products in the company's quality control lab. The job requires inspectors to randomly check products coming off the assembly line for defects. Historically, all inspectors have stood two-hour shifts. Ernest proposes to sit in his wheelchair. The company refuses to hire him because it says he will be less efficient. Ernest's previous employment record shows him to be a diligent, serious worker. Does Ernest have a legal right to be hired? What additional facts might you want to know in deciding?
4. Marlene works for Frenzied Traders, a stockbrokerage with a seat on the New York Stock Exchange. For several years, Marlene has been a floor trader, spending all day in the hurly-burly of stock trading, yelling herself hoarse. Each year, she has received a large bonus from the company. She has just told the company that she is pregnant. Citing a company policy, she is told she can no longer engage in trading because it is too tiring for pregnant women. Instead, she may take a backroom job, though the company cannot guarantee that the floor job will be open after she delivers. Marlene also wants to take six months off after her child is born. The company says it cannot afford to give her that time. It has a policy of granting paid leave to anyone recuperating from a stay in the hospital and unpaid leave for four months thereafter. What legal rights does Marlene have, and what remedies is she entitled to?
5. Charlie Goodfellow works for Yum-burger and has always commanded respect at the local franchise for being the fastest server. One day, he undergoes a profound religious experience, converts to Sikhism, and changes his name to Sanjay Singh. The tenets of his religion require him to wear a beard and a turban. He lets his beard grow, puts on a turban, and his fellow workers tease him. When a regional vice president sees that Sanjay is not wearing the prescribed Yum-Burger uniform, he fires him. What rights of Sanjay, if any, has Yum-burger violated? What remedies are available to him?

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CHAPTER OVERVIEW

12: Partnerships—General Characteristics and Formation

Learning Objectives

After reading this chapter, you should understand the following:

- The importance of partnerships and the present status of partnership law
- The extent to which a partnership is an entity
- The tests that determine whether a partnership exists
- Partnership by estoppel
- Partnership formation

12.1: Introduction to Partnerships and Entity Theory
12.2: Partnership Formation
12.3: Summary and Exercises

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12.1: Introduction to Partnerships and Entity Theory

Learning Objectives

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

- Describe the importance of partnership.
- Understand partnership history.
- Identify the entity characteristics of partnerships.

Importance of Partnership Law

It would be difficult to conceive of a complex society that did not operate its businesses through organizations. In this chapter we study partnerships, limited partnerships, and limited liability companies, and we touch on joint ventures and business trusts.

When two or more people form their own business or professional practice, they usually consider becoming partners. Partnership law defines a partnership as "the association of two or more persons to carry on as co-owners a business for profit…whether or not the persons intend to form a partnership."Revised Uniform Partnership Act, Section 202(a). The Internal Revenue Service reports there are more than four million business firms in the United States as partnerships and partnerships are a common form of organization among accountants, lawyers, doctors, and other professionals. When we use the word *partnership*, we are referring to the *general business partnership*. There are also limited partnerships and limited liability partnerships, which are discussed later in this text.

Partnerships are also popular as investment vehicles. Partnership law and tax law permit an investor to put capital into a limited partnership and realize tax benefits without liability for the acts of the general partners.

Even if you do not plan to work within a partnership, it can be important to understand the law that governs it. Why? Because it is possible to become someone's partner without intending to or even realizing that a partnership has been created. Knowledge of the law can help you avoid partnership liability.

History of Partnership Law

Through the Twentieth Century

Partnership is an ancient form of business enterprise, and special laws governing partnerships date as far back as 2300 BC, when the Code of Hammurabi explicitly regulated the relations between partners. Partnership was an important part of Roman law, and it played a significant role in the law merchant, the international commercial law of the Middle Ages.

In the nineteenth century, in both England and the United States, partnership was a popular vehicle for business enterprise. But the law governing it was jumbled. Common-law principles were mixed with equitable standards, and the result was considerable confusion. Parliament moved to reduce the uncertainty by adopting the Partnership Act of 1890, but codification took longer in the United States. The Commissioners on Uniform State Laws undertook the task at the turn of the twentieth century. The Uniform Partnership Act (UPA), completed in 1914, and the Uniform Limited Partnership Act (ULPA), completed in 1916, were the basis of partnership law for many decades. UPA and ULPA were adopted by all states except Louisiana.

Entity Theory

Meaning of "Legal Entity"

A significant difference between a partnership and most other kinds of business organization relates to whether, and the extent to which, the business is a legal entity. A legal entity is a person or group that the law recognizes as having legal rights, such as the right to own and dispose of property, to sue and be sued, and to enter into contracts; the entity theory is the concept of a business firm as a legal person, with existence and accountability separate from its owners. When individuals carry out a common enterprise as partners, a threshold legal question is whether the partnership is a legal entity. The common law said no. In other words, under the common-law theory, a partnership was but a convenient name for an aggregate of individuals, and the rights and duties

recognized and imposed by law are those of the individual partners. By contrast, the mercantile theory of the law merchant held that a partnership is a legal entity that can have rights and duties independent of those of its members.

During the drafting of the 1914 UPA, a debate raged over which theory to adopt. The drafters resolved the debate through a compromise. In Section 6(1), UPA provides a neutral definition of partnership ("an association of two or more persons to carry on as co-owners a business for profit") and retained the common-law theory that a partnership is an aggregation of individuals—the aggregate theory.

Entity Characteristics of a Partnership

Under UPA, then, a partnership has entity characteristics, but the partners remain guarantors of partnership obligations, as always—that is the partners' joint and several liability noted in the previous paragraph. This is a very important point and a primary weakness of the partnership form: all partners are, and each one of them is, ultimately personally liable for the obligations of the partnership, without limit, which includes personal and unlimited liability. This personal liability is very distasteful, and it has been abolished, subject to some exceptions, with limited partnerships and limited liability companies. And, of course, the owners of corporations are also not generally liable for the corporation's obligations, which is a major reason for the corporate form's popularity.

For Accounting Purposes

Under both versions of the law, the partnership may keep business records as if it were a separate entity, and its accountants may treat it as such for purposes of preparing income statements and balance sheets.

For Purposes of Taxation

Under both versions of the law, partnerships are *not* taxable entities, so they do not pay income taxes. Instead, each partner's distributive share, which includes income or other gain, loss, deductions, and credits, must be included in the partner's personal income tax return, whether or not the share is actually distributed.

For Purposes of Litigation

In litigation, the aggregate theory causes some inconvenience in naming and serving partnership defendants: under UPA, lawsuits to enforce a partnership contract or some other right must be filed in the name of all the partners. Similarly, to sue a partnership, the plaintiff must name and sue each of the partners. This cumbersome procedure was modified in many states, which enacted special statutes expressly permitting suits by and against partnerships in the firm name. In suits on a claim in federal court, a partnership may sue and be sued in its common name.

For Purposes of Owning Real Estate

Aggregate theory concepts bedeviled property co-ownership issues, so UPA finessed the issue by stating that partnership property, real or personal, could be held in the name of the partners as "tenants in partnership"—a type of co-ownership—or it could be held in the name of the partnership.Uniform Partnership Act, Section 25(1); UPA, Section 8(3). A partner may bring onto the partnership premises her own property, not acquired in the name of the partnership or with its credit, and it remains her separate property. Under the law a partner cannot unilaterally dispose of partnership property, however labeled, for the obvious reason that one cannot dispose of another's property or property rights without permission. And keep in mind that partnership law is the default: partners are free to make up partnership agreements as they like, subject to some limitations. They are free to set up property ownership rules as they like.

For Purposes of Bankruptcy

Under federal bankruptcy law—state partnership law is preempted—a partnership is an entity that may voluntarily seek the haven of a bankruptcy court or that may involuntarily be thrust into a bankruptcy proceeding by its creditors. The partnership cannot discharge its debts in a liquidation proceeding under Chapter 7 of the bankruptcy law, but it can be rehabilitated under Chapter 11.

Key Takeaway

Partnership law is very important because it is the way most small businesses are organized and because it is possible for a person to become a partner without intending to. Partnership law goes back a long way, but in the United States, most states—but not all—

have adopted the Revised Uniform Partnership Act (RUPA, 1997) over the previous Uniform Partnership Act, originally promulgated in 1914. A partnership is an entity: it is like a person for purposes of accounting, litigation, bankruptcy, and owning real estate. Partnerships do not pay taxes; the individual partners do.

Exercises

1. When was UPA set out for states to adopt?
2. What does it mean to say that the partnership act is the “default position”? For what types of partnership is UPA likely to be of most importance?
3. What is the aggregate theory of partnership? The entity theory?

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12.2: Partnership Formation

Learning Objectives

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

- Describe the creation of an express partnership.
- Describe the creation of an implied partnership.
- Identify tests of partnership existence.
- Understand partnership by estoppel.

Creation of an Express Partnership

Creation in General

The most common way of forming a partnership is expressly—that is, in words, orally or in writing. Such a partnership is called an express partnership. If parties have an express partnership with no partnership agreement, the relevant law—the Uniform Partnership Act (UPA)—applies the governing rules.

Assume that three persons have decided to form a partnership to run a car dealership. Able contributes $250,000. Baker contributes the building and space in which the business will operate. Carr contributes his services; he will manage the dealership.

The first question is whether Able, Baker, and Carr must have a partnership agreement. As should be clear from the foregoing discussion, no agreement is necessary as long as the tests of partnership are met. However, they *ought* to have an agreement in order to spell out their rights and duties among themselves.

The agreement itself is a contract and should follow the principles and rules spelled out in this book. Because the agreement is intended to govern the relations of the partners toward themselves and their business, every partnership contract should set forth clearly the following terms: (1) the name under which the partners will do business; (2) the names of the partners; (3) the nature, scope, and location of the business; (4) the capital contributions of each partner; (5) how profits and losses are to be divided; (6) how salaries, if any, are to be determined; (7) the responsibilities of each partner for managing the business; (8) limitations on the power of each partner to bind the firm; (9) the method by which a given partner may withdraw from the partnership; (10) continuation of the firm in the event of a partner's death and the formula for paying a partnership interest to his heirs; and (11) method of dissolution.

Specific Issues of Concern

In forming a partnership, three of these items merit special attention.

Who Can Be a Partner?

As discussed earlier in this chapter, a partnership is not limited to a direct association between human beings but may also include an association between other entities, such as corporations or even partnerships themselves. A **joint venture**—sometimes known as a joint adventure, coadventure, joint enterprise, joint undertaking, syndicate, group, or pool—is an association of persons to carry on a particular task until completed. In essence, a joint venture is a "temporary partnership." In the United States, the use of joint ventures began with the railroads in the late 1800s. Throughout the middle part of the twentieth century joint ventures were common in the manufacturing sector. By the late 1980s, they increasingly appeared in both manufacturing and service industries as businesses looked for new, competitive strategies. They are aggressively promoted on the Internet: "Joint Ventures are in, and if you're not utilizing this strategic weapon, chances are your competition is, or will soon be, using this to their advantage.…possibly against you!" (Scott Allen, "Joint Venturing 101," About.com Entrepreneurs.)

As a risk-avoiding device, the joint venture allows two or more firms to pool their differing expertise so that neither needs to "learn the ropes" from the beginning; neither needs the entire capital to start the enterprise. Partnership rules generally apply, although the relationship of the joint venturers is closer to that of special than general agency. Joint venturers are fiduciaries toward one another. Although no formality is necessary, the associates will usually sign an agreement. The joint venture need have no group name, though it may have one. Property may be owned jointly. Profits and losses will be shared, as in a partnership, and each associate

has the right to participate in management. Liability is unlimited. Sometimes two or more businesses will form a joint venture to carry out a specific task—prospecting for oil, building a nuclear reactor, doing basic scientific research—and will incorporate the joint venture. In that case, the resulting business—known as a "joint venture corporation"—is governed by corporation law, not the law of partnership, and is not a joint venture in the sense described here. Increasingly, companies are forming joint ventures to do business abroad; foreign investors or governments own significant interests in these joint ventures.

Written versus Oral Agreements

If the business cannot be performed within one year from the time that the agreement is entered into, the partnership agreement should be in writing to avoid invalidation under the Statute of Frauds. Most partnerships have no fixed term, however, and are partnerships "at will" and therefore not covered by the Statute of Frauds.

Validity of the Partnership Name

Able, Baker, and Carr decide that it makes good business sense to choose an imposing, catchy, and well-known name for their dealership—General Motors Corporation. There are two reasons why they cannot do so. First, their business is a partnership, not a corporation, and should not be described as one. Second, the name is deceptive because it is the name of an existing business. Furthermore, if not registered, the name would violate the assumed or fictitious name statutes of most states. These require that anyone doing business under a name other than his real name register the name, together with the names and addresses of the proprietors, in some public office. (Often, the statutes require the proprietors to publish this information in the newspapers when the business is started.)

Creation of Implied Partnership

An implied partnership exists when in fact there are two or more persons carrying on a business as co-owners for profit. For example, Carlos decides to paint houses during his summer break. He gathers some materials and gets several jobs. He hires Wally as a helper. Wally is very good, and pretty soon both of them are deciding what jobs to do and how much to charge, and they are splitting the profits. They have an implied partnership, without intending to create a partnership at all.

Tests of Partnership Existence

But how do we know whether an implied partnership *has* been created? Obviously, we know if there is an express agreement. But partnerships can come into existence quite informally, indeed, without any formality—they can be created accidentally. In contrast to the corporation, which is the creature of statute, partnership is a catchall term for a large variety of working relationships, and frequently, uncertainties arise about whether or not a particular relationship is that of partnership. The law can reduce the uncertainty in advance only at the price of severely restricting the flexibility of people to associate. As the chief drafter of the Uniform Partnership Act (UPA, 1914) explained,

All other business associations are statutory in origin. They are formed by the happening of an event designated in a statute as necessary to their formation. In corporations this act may be the issuing of a charter by the proper officer of the state; in limited partnerships, the filing by the associates of a specified document in a public office. On the other hand, an infinite number of combinations of circumstances may result in co-ownership of a business. Partnership is the residuum, including all forms of co-ownership, of a business except those business associations organized under a specific statute.

(W. D. Lewis, "The Uniform Partnership Act," *Yale Law Journal* 24 (1915): 617, 622.)



Figure 18.1 Partnership Tests

Because it is frequently important to know whether a partnership exists (as when a creditor has dealt with only one party but wishes to also hold others liable by claiming they were partners. We return to the definition of a partnership: "the association of two or more persons to carry on as co-owners a business for profit[.]" The three elements are (1) the association of persons, (2) as co-owners, (3) for profit.

Association of Persons

This element is pretty obvious. A partnership is a contractual agreement among persons, so the persons involved need to have *capacity* to contract. But UPA does not provide that only *natural* persons can be partners; it defines *person* as follows: "'Person' means an individual, corporation, business trust, estate, trust, partnership, association, joint venture, government, governmental subdivision, agency, or instrumentality, or any other legal or commercial entity." Thus unless state law precludes it, a corporation can be a partner in a partnership.

Co-owners of a Business

If what two or more people own is clearly a business—including capital assets, contracts with employees or agents, an income stream, and debts incurred on behalf of the operation—a partnership exists. A tougher question arises when two or more persons co-own property. Do they automatically become partners? The answer can be important: if one of the owners while doing business pertinent to the property injures a stranger, the latter could sue the other owners if there is a partnership.

Co-ownership comes in many guises. The four most common are joint tenancy, tenancy in common, tenancy by the entireties, and community property. In joint tenancy, the owners hold the property under a single instrument, such as a deed, and if one dies, the others automatically become owners of the deceased's share, which does not descend to his heirs. Tenancy in common has the reverse rule: the survivor tenants do not take the deceased's share. Each tenant in common has a distinct estate in the property. The tenancy by the entirety and community property (in community-property states) forms of ownership are limited to spouses, and their effects are similar to that of joint tenancy.

Suppose a husband and wife who own their home as tenants by the entirety (or community property) decide to spend the summer at the seashore and rent their home for three months. Is their co-ownership sufficient to establish that they are partners? The answer is no. By UPA Section 7(2), the various forms of joint ownership by themselves do not establish partnership, whether or not the co-owners share profits made by the use of the property. To establish a partnership, the ownership must be of a business, not merely of property.

Sharing of Profits

There are two aspects to consider with regard to profits: first, whether the business is for-profit, and second, whether there is a sharing of the profit.

Business for Profit

Unincorporated nonprofit organizations (UNAs) cannot be partnerships. The paucity of coherent law governing these organizations gave rise in 2005 to the National Conference of Commissioners of Uniform Laws' promulgation of the Revised Uniform Unincorporated Nonprofit Association Act (RUUNAA). The prefatory note to this act says, "RUUNAA was drafted with small informal associations in mind. These informal organizations are likely to have no legal advice and so fail to consider legal and organizational questions, including whether to incorporate. The act provides better answers than the common law for a limited number of legal problems…There are probably hundreds of thousands of UNAs in the United States including unincorporated nonprofit philanthropic, educational, scientific and literary clubs, sporting organizations, unions, trade associations, political organizations, churches, hospitals, and condominium and neighborhood associations.""

Sharing the Profit

While co-ownership does not establish a partnership unless there is a business, a business by itself is not a partnership unless co-ownership is present. Of the tests used by courts to determine co-ownership, perhaps the most important is sharing of profits. The UPA provides effectively provides that a person who receives a share of the profits of a business is presumed to be a partner in the business," but this presumption can be rebutted by applying a varity of factors identified under the UPA.

Key Takeaway

A partnership is any two or more persons—including corporate persons—carrying on a business as co-owners for profit. A primary test of whether a partnership exists is whether there is a sharing of profits, though other factors such as sharing decision making, sharing liabilities, and how the business is operated are also examined.

Most partnerships are expressly created. Several factors become important in the partnership agreement, whether written or oral. These include the name of the business, the capital contributions of each partner, profit sharing, and decision making.

Exercises

1. Why is it necessary—or at least useful—to have tests to determine whether a partnership exists?
2. What elements of the business organization are examined to make this determination?
3. Jacob rents farmland from Davis and pays Davis a part of the profits from the crop in rent. Is Davis a partner? What if Davis offers suggestions on what to plant and when? Now is he a partner?
4. What elements should be included in a written partnership agreement?
5. What is an implied partnership?

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12.3: Summary and Exercises

Summary

The basic law of partnership is found in the Uniform Partnership Act and Revised Uniform Partnership Act. The latter has been adopted by thirty-five states. At common law, a partnership was not a legal entity and could not sue or be sued in the partnership name. Partnership law defines a partnership as “an association of two or more persons to carry on as co-owners a business for profit.” The Uniform Partnership Act (UPA) assumes that a partnership is an aggregation of individuals, but it also applies a number of rules characteristic of the legal entity theory.

Partnerships may be created informally. Among the clues to the existence of a partnership are (1) co-ownership of a business, (2) sharing of profits, (3) right to participate in decision making, (4) duty to share liabilities, and (5) manner in which the business is operated. A partnership may also be formed by implication; it may be formed by estoppel when a third party reasonably relies on a representation that a partnership in fact exists.

No special rules govern the partnership agreement. As a practical matter, it should sufficiently spell out who the partners are, under what name they will conduct their business, the nature and scope of the business, capital contributions of each partner, how profits are to be divided, and similar pertinent provisions. An oral agreement to form a partnership is valid unless the business cannot be performed wholly within one year from the time that the agreement is made. However, most partnerships have no fixed terms and hence are “at-will” partnerships not subject to the Statute of Frauds.

Exercises

1. Able, Baker, and Carr own, as partners, a warehouse. The income from the warehouse during the current year is $300,000, two-thirds of which goes to Able. Who must file a tax return listing this as income, the partnership or Able? Who pays the tax, the partnership or Able?
2. The Havana Club operated in Salt Lake City under a lease running to defendant Dale Bowen, who owned the equipment, furnishings, and inventory. He did not himself work in operating the club. He made an oral agreement with Frances Cutler, who had been working for him as a bartender, that she take over the management of the club. She was to have the authority and the responsibility for the entire active management and operation: to purchase the supplies, pay the bills, keep the books, hire and fire employees, and do whatever else was necessary to run the business. As compensation, the arrangement was for a down-the-middle split; each was to receive $300 per week plus one half of the net profits. This went on for four years until the city took over the building for a redevelopment project. The city offered Bowen $30,000 as compensation for loss of business while a new location was found for the club. Failing to find a suitable location, the parties decided to terminate the business. Bowen then contended he was entitled to the entire $30,000 as the owner, Cutler being an employee only. She sued to recover half as a partner. What was the result? Decide and discuss.
3. Raul, a business student, decided to lease and operate an ice cream stand during his summer vacation. Because he could not afford rent payments, his lessor agreed to take 30 percent of the profits as rent and provide the stand and the parcel of real estate on which it stood. Are the two partners?
4. Able, Baker, and Carr formed the ABC Partnership in 2001. In 2002 Able gave her three sons, Duncan, Eldon, and Frederick, a gift of her 41 percent interest in the partnership to provide money to pay for their college expenses. The sons reported income from the partnership on their individual tax returns, and the partnership reported the payment to them on its information return. The sons were listed as partners on unaudited balance sheets in 2003, and the 2004 income statement listed them as partners. The sons never requested information about the management of the firm, never attended any meetings or voted, and never attempted to withdraw the firm’s money or even speak with the other partners about the firm. Two of the sons didn’t know where the firm was located, but they all once received “management fees” totaling $3,000, without any showing of what the “fees” were for. In 2005, the partnership incurred liability for pension-fund contributions to an employee, and a trustee for the fund asserted that Able’s sons were personally liable under federal law for the money owing because they were partners. The sons moved for summary judgment denying liability. How should the court rule?
5. The Volkmans wanted to build a house and contacted David McNamee for construction advice. He told them that he was doing business with Phillip Carroll. Later the Volkmans got a letter from McNamee on stationery that read “DP Associates,” which they assumed was derived from the first names of David and Phillip. At the DP Associates office McNamee introduced Mr.

Volkman to Carroll, who said to Volkman, “I hope we’ll be working together.” At one point during the signing process a question arose and McNamee said, “I will ask Phil.” He returned with the answer to the question. After the contract was signed but before construction began, Mr. Volkman visited the DP Associates office where the two men chatted; Carroll said to him, “I am happy that we will be working with you.” The Volkmans never saw Carroll on the construction site and knew of no other construction supervised by Carroll. They understood they were purchasing Carroll’s services and construction expertise through DP Associates. During construction, Mr. Volkman visited the DP offices several times and saw Carroll there. During one visit, Mr. Volkman expressed concerns about delays and expressed the same to Carroll, who replied, “Don’t worry. David will take care of it.” But David did not, and the Volkmans sued DP Associates, McNamee, and Carroll. Carroll asserted he could not be liable because he and McNamee were not partners. The trial court dismissed Carroll on summary judgment; the Volkmans appealed. How should the court rule on appeal?

6. Wilson and VanBeek want to form a partnership. Wilson is seventeen and VanBeek is twenty-two. May they form a partnership? Explain.
7. Diane and Rachel operate a restaurant at the county fair every year to raise money for the local 4-H Club. They decide together what to serve, what hours to operate, and generally how to run the business. Do they have a partnership?

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CHAPTER OVERVIEW

13: Corporation—General Characteristics and Formation

Learning Objectives

After reading this chapter, you should understand the following:

- The historical background of the corporation
- How partnerships compare with corporations
- What the corporation is as a legal entity, and how corporate owners can lose limited liability by certain actions
- How corporations are classified

The corporation is the dominant form of the business enterprise in the modern world. As a legal entity, it is bound by much of the law discussed in the preceding chapters. However, as a significant institutional actor in the business world, the corporation has a host of relationships that have developed as a separate body of law.

13.1: Historical Background

13.2: Partnerships versus Corporations

13.3: The Corporate Veil- The Corporation as a Legal Entity

13.4: Classifications of Corporations

13.5: Corporate Organization

13.6: Summary and Exercises

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13.1: Historical Background

Learning Objectives

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

- Comprehend the historical significance of corporate formation.
- Learn about key court decisions and their effect on interstate commerce and corporate formation.
- Become acquainted with how states formed their corporate laws.

A Fixture of Every Major Legal System

Like partnership, the corporation is an ancient concept, recognized in the Code of Hammurabi, and to some degree a fixture in every other major legal system since then. The first corporations were not business enterprises; instead, they were associations for religious and governmental ends in which perpetual existence was a practical requirement. Thus until relatively late in legal history, kings, popes, and jurists assumed that corporations could be created only by political or ecclesiastical authority and that corporations were creatures of the state or church. By the seventeenth century, with feudalism on the wane and business enterprise becoming a growing force, kings extracted higher taxes and intervened more directly in the affairs of businesses by refusing to permit them to operate in corporate form except by royal grant. This came to be known as the concession theory, because incorporation was a concession from the sovereign.

The most important concessions, or charters, were those given to the giant foreign trading companies, including the Russia Company (1554), the British East India Company (1600), Hudson's Bay Company (1670, and still operating in Canada under the name "the Bay"), and the South Sea Company (1711). These were joint-stock companies—that is, individuals contributed capital to the enterprise, which traded on behalf of all the stockholders. Originally, trading companies were formed for single voyages, but the advantages of a continuing fund of capital soon became apparent. Also apparent was the legal characteristic that above all led shareholders to subscribe to the stock: limited liability. They risked only the cash they put in, not their personal fortunes.

Some companies were wildly successful. The British East India Company paid its original investors a fourfold return between 1683 and 1692. But perhaps nothing excited the imagination of the British more than the discovery of gold bullion aboard a Spanish shipwreck; 150 companies were quickly formed to salvage the sunken Spanish treasure. Though most of these companies were outright frauds, they ignited the search for easy wealth by a public unwary of the risks. In particular, the South Sea Company promised the sun and the moon: in return for a monopoly over the slave trade to the West Indies, it told an enthusiastic public that it would retire the public debt and make every person rich.

In 1720, a fervor gripped London that sent stock prices soaring. Beggars and earls alike speculated from January to August; and then the bubble burst. Without considering the ramifications, Parliament had enacted the highly restrictive Bubble Act, which was supposed to do away with unchartered **joint-stock** companies. When the government prosecuted four companies under the act for having fraudulently obtained charters, the public panicked and stock prices came tumbling down, resulting in history's first modern financial crisis.

As a consequence, corporate development was severely retarded in England. Distrustful of the chartered company, Parliament issued few corporate charters, and then only for public or quasi-public undertakings, such as transportation, insurance, and banking enterprises. Corporation law languished: William Blackstone devoted less than 1 percent of his immensely influential *Commentaries on the Law of England* (1765) to corporations and omitted altogether any discussion of limited liability. In *The Wealth of Nations* (1776), Adam Smith doubted that the use of corporations would spread. England did not repeal the Bubble Act until 1825, and then only because the value of true incorporation had become apparent from the experience of its former colonies.

US Corporation Formation

The United States remained largely unaffected by the Bubble Act. Incorporation was granted only by special acts of state legislatures, even well into the nineteenth century, but many such acts were passed. Before the Revolution, perhaps fewer than a dozen business corporations existed throughout the thirteen colonies. During the 1790s, two hundred businesses were incorporated, and their numbers swelled thereafter. The theory that incorporation should not be accomplished except through special legislation

began to give way. As industrial development accelerated in the mid-1800s, it was possible in many states to incorporate by adhering to the requirements of a general statute. Indeed, by the late nineteenth century, all but three states constitutionally *forbade* their legislatures from chartering companies through special enactments.

The US Supreme Court contributed importantly to the development of corporate law. In *Gibbons v. Ogden*, 22 U.S. 1 (1824) a groundbreaking case, the Court held that the Commerce Clause of the US Constitution (Article I, Section 8, Clause 3) granted Congress the power to regulate interstate commerce. However, in *Paul v. Virginia*, 75 U.S. 168 (1868) the Court said that a state could prevent corporations not chartered there—that is, **out-of-state or** foreign corporations—from engaging in what it considered the local, and not interstate, business of issuing insurance policies. The inference made by many was that states could not bar foreign corporations engaged in *interstate* business from their borders.

This decision brought about a competition in corporation laws. The early general laws had imposed numerous restrictions. The breadth of corporate enterprise was limited, ceilings were placed on total capital and indebtedness, incorporators were required to have residence in the state, the duration of the company often was not perpetual but was limited to a term of years or until a particular undertaking was completed, and the powers of management were circumscribed. These restrictions and limitations were thought to be necessary to protect the citizenry of the chartering legislature's own state. But once it became clear that companies chartered in one state could operate in others, states began in effect to "sell" incorporation for tax revenues.

New Jersey led the way in 1875 with a general incorporation statute that greatly liberalized the powers of management and lifted many of the former restrictions. The Garden State was ultimately eclipsed by Delaware, which in 1899 enacted the most liberal corporation statute in the country, so that to the present day there are thousands of "Delaware corporations" that maintain no presence in the state other than an address on file with the secretary of state in Dover.

During the 1920s, the National Conference of Commissioners on Uniform State Laws drafted a Uniform Business Corporation Act, the final version of which was released in 1928. It was not widely adopted, but it did provide the basis during the 1930s for revisions of some state laws, including those in California, Illinois, Michigan, Minnesota, and Pennsylvania. By that time, in the midst of the Great Depression, the federal government for the first time intruded into corporate law in a major way by creating federal agencies, most notably the Securities and Exchange Commission in 1934, with power to regulate the interstate issuance of corporate stock.

Corporate Law Today

Following World War II, most states revised their general corporation laws. A significant development for states was the preparation of the Model Business Corporation Act by the American Bar Association's Committee on Corporate Laws. About half of the states have adopted all or major portions of the act. The 2016 version of this act (last revised in 2021), the Revised Model Business Corporation Act (RMBCA), will be referred to throughout our discussion of corporation law.

Key Takeaway

Corporations have their roots in political and religious authority. The concept of limited liability and visions of financial rewards fueled the popularity of joint-stock companies, particularly trading companies, in late-seventeenth- and early eighteenth-century England. The English Parliament successfully enacted the Bubble Act in 1720 to curb the formation of these companies; the restrictions weren't loosened until over one hundred years later, after England viewed the success of corporations in its former colonies. Although early corporate laws in the United States were fairly restrictive, once states began to "sell" incorporation for tax revenues, the popularity of liberal and corporate-friendly laws caught on, especially in Delaware beginning in 1899. A corporation remains a creature of the state—that is, the state in which it is incorporated. Delaware remains the state of choice because more corporations are registered there than in any other state.

Exercises

1. If the English Parliament had not enacted the Bubble Act in 1720, would the "bubble" have burst? If so, what would have been the consequences to corporate development?
2. What were some of the key components of early US corporate laws? What was the rationale behind these laws?
3. In your opinion, what are some of the liberal laws that attract corporations to Delaware?

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13.2: Partnerships versus Corporations

Learning Objectives

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

- Distinguish basic aspects of partnership formation from those of corporate formation.
- Explain ownership and control in partnerships and in publicly held and closely held corporations.
- Know how partnerships and corporations are taxed.

Let us assume that three people have already formed a partnership to run a bookstore business. Bob has contributed $80,000. Carol has contributed a house in which the business can lawfully operate. Ted has contributed his services; he has been managing the bookstore, and the business is showing a slight profit. A friend has been telling them that they ought to incorporate. What are the major factors they should consider in reaching a decision?

Ease of Formation

Partnerships are easy to form. If the business is simple enough and the partners are few, the agreement need not even be written down. Creating a corporation is more complicated because formal documents must be placed on file with public authorities.

Ownership and Control

All general partners have equal rights in the management and conduct of the business. By contrast, ownership and control of corporations are, in theory, separated. In the publicly held corporation, which has many shareholders, the separation is real. Ownership is widely dispersed because millions of shares are outstanding and it is rare that any single shareholder will own more than a tiny percentage of stock. It is difficult under the best of circumstances for shareholders to exert any form of control over corporate operations. However, in the closely held corporation, which has few shareholders, the officers or senior managers are usually also the shareholders, so the separation of ownership and control may be less pronounced or even nonexistent.

Liability

A corporation is a separate legal entity, whereas a general partnership is not. The assets and liabilities of the corporation are held by the corporation. An individual owner's share of those assets--and liabilities--extends only as far as her ownership interest in the corporation. If the corporation is sued for negligence, the corporation will be liable for the losses and not the individual shareholders. At worst, the company goes bankrupt and its individual owners lose their investments in the corporation. In contrast, general partners are wholly liable for the losses caused by the partnership. They risk their personal assets for any losses incurred by the partnership.

Transferability of Interests

Transferability of an interest in a partnership is a problem because a transferee cannot become a member unless all partners consent. The problem can be addressed and overcome in the partnership agreement. Transfer of interest in a corporation, through a sale of stock, is much easier; but for the stock of a small corporation, there might not be a market or there might be contractual restrictions on transfer.

Financing

Partners have considerable flexibility in financing. They can lure potential investors by offering interests in profits and, in the case of general partnerships, control. Corporations can finance by selling freely transferable stock to the public or by incurring debt. Different approaches to the financing of corporations are discussed in “Legal Aspects of Corporate Finance”.

Taxation

The partnership is a conduit for income and is not taxed as a separate entity. Individual partners are taxed, and although limited by the 1986 Tax Reform Act, they can deduct partnership losses. Corporate earnings, on the other hand, are subject to double taxation. The corporation is first taxed on its own earnings as an entity. Then, when profits are distributed to shareholders in the form of

dividends, the shareholders are taxed again. However, incorporating brings several tax benefits. For example, the corporation can take deductions for life, medical, and disability insurance coverage for its employees, whereas partners or sole proprietors cannot.

Key Takeaway

Partnerships are easier to form than corporations, especially since no documents are required. General partners share both ownership and control, but in publicly held corporations, these functions are separated. Additional benefits for a partnership include flexibility in financing, single taxation, and the ability to deduct losses. Transfer of interest in a partnership can be difficult if not addressed in the initial agreement, since all partners must consent to the transfer.

Exercises

1. Provide an example of when it would be best to form a partnership, and cite the advantages and disadvantages of doing so.
2. Provide an example of when it would be best to form a corporation, and cite the advantages and disadvantages of doing so.

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13.3: The Corporate Veil- The Corporation as a Legal Entity

Learning Objectives

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

- Know what rights a corporate "person" and a natural person have in common.
- Recognize when a corporate "veil" is pierced and shareholder liability is imposed.
- Identify other instances when a shareholder will be held personally liable.

In comparing partnerships and corporations, there is one additional factor that ordinarily tips the balance in favor of incorporating: the corporation is a legal entity in its own right, one that can provide a "veil" that protects its shareholders from personal liability.

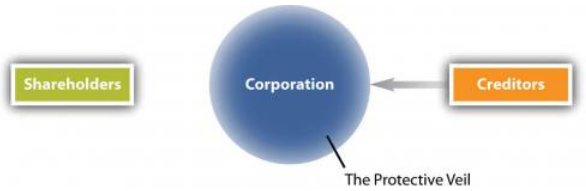


Figure 21.1 The Corporate Veil

This crucial factor accounts for the development of much of corporate law. Unlike the individual actor in the legal system, the corporation is difficult to deal with in conventional legal terms. The business of the sole proprietor and the sole proprietor herself are one and the same. When a sole proprietor makes a decision, she risks her own capital. When the managers of a corporation take a corporate action, they are risking the capital of others—the shareholders. Thus accountability is a major theme in the system of law constructed to cope with legal entities other than natural persons.

The Basic Rights of the Corporate "Person"

To say that a corporation is a "person" does not automatically describe what its rights are, for the courts have not accorded the corporation every right guaranteed a natural person. Yet the Supreme Court recently affirmed in *Citizens United v. Federal Election Commission* (2010) that the government may not suppress the First Amendment right of political speech because the speaker is a corporation rather than a natural person. According to the Court, "No sufficient governmental interest justifies limits on the political speech of nonprofit or for-profit corporations." (*Citizens United v. Federal Election Commission*, 558 U.S. 310 (2010).)

The courts have also concluded that corporations are entitled to the essential constitutional protections of due process and equal protection. They are also entitled to Fourth Amendment protection against unreasonable search and seizure; in other words, the police must have a search warrant to enter corporate premises and look through files. Warrants, however, are not required for highly regulated industries, such as those involving liquor or guns. The Double Jeopardy Clause applies to criminal prosecutions of corporations: an acquittal cannot be appealed nor can the case be retried. For purposes of the federal courts' diversity jurisdiction, a corporation is deemed to be a citizen of both the state in which it is incorporated and the state in which it has its principal place of business (often, the corporate "headquarters").

Until relatively recently, few cases had tested the power of the state to limit the right of corporations to spend their own funds to speak the "corporate mind." Most cases involving corporate free speech address advertising, and few states have enacted laws that directly impinge on the freedom of companies to advertise. But those states that have done so have usually sought to limit the ability of corporations to sway voters in public referenda. In 1978, the Supreme Court finally confronted the issue head on in *First National Bank of Boston v. Bellotti* (Section 21.7.1 "Limiting a Corporation's First Amendment Rights"). The ruling in *Bellotti* was reaffirmed by the Supreme Court in *Citizens United v. Federal Election Commission*. In *Citizens United*, the Court struck down the part of the McCain-Feingold Act that prohibited all corporations, both for-profit and not-for-profit, and unions from broadcasting "electioneering communications."

Absence of Rights

Corporations lack certain rights that natural persons possess. For example, corporations do not have the privilege against self-incrimination guaranteed for natural persons by the Fifth and Fourteenth Amendments. In any legal proceeding, the courts may

force a corporation to turn over incriminating documents, even if they also incriminate officers or employees of the corporation. Corporations are not citizens under the Privileges and Immunities Clause of the Constitution, so that the states can discriminate between domestic and foreign corporations. And the corporation is not entitled to federal review of state criminal convictions, as are many individuals.

Piercing the Corporate Veil

Given the importance of the corporate entity as a veil that limits shareholder liability, it is important to note that in certain circumstances, the courts may reach beyond the wall of protection that divides a corporation from the people or entities that exist behind it. Disregarding the corporate status that protects shareholders from liability and, instead, holding shareholders personally liable for acts committed in the corporation's name is known as "piercing the corporate veil", and it will occur in two instances: (1) when the corporation is used to commit a fraud or an injustice and (2) when the corporation does not act as if it were one.

Fraud

The Felsenthal Company burned to the ground. Its president, one of the company's largest creditors and also virtually its sole owner, instigated the fire. The corporation sued the insurance company to recover the amount for which it was insured. According to the court in the Felsenthal case, "The general rule of law is that the willful burning of property by a stockholder in a corporation is not a defense against the collection of the insurance by the corporation, and…the corporation cannot be prevented from collecting the insurance because its agents willfully set fire to the property without the participation or authority of the corporation or of all of the stockholders of the corporation."(*D. I. Felsenthal Co. v. Northern Assurance Co., Ltd.*, 284 Ill. 343, 120 N.E. 268 (1918).) But because the fire was caused by the beneficial owner of "practically all" the stock, who also "has the absolute management of [the corporation's] affairs and its property, and is its president," the court refused to allow the company to recover the insurance money; allowing the company to recover would reward fraud.

Failure to Act as a Corporation

In other limited circumstances, individual stockholders may also be found personally liable. Failure to follow corporate formalities, for example, may subject stockholders to personal liability. This is a special risk that small, especially one-person, corporations run. Particular factors that bring this rule into play include inadequate capitalization, omission of regular meetings, failure to record minutes of meetings, failure to file annual reports, and commingling of corporate and personal assets. Where these factors exist, the courts may look through the corporate veil and pluck out the individual stockholder or stockholders to answer for a tort, contract breach, or the like. The classic case is the taxicab operator who incorporates several of his cabs separately and services them through still another corporation. If one of the cabs causes an accident, the corporation is usually "judgment proof" because the corporation will have few assets (practically worthless cab, minimum insurance). The courts frequently permit plaintiffs to proceed against the common owner on the grounds that the particular corporation was inadequately financed.

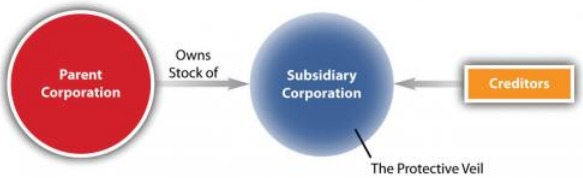


Figure 21.2 The Subsidiary as a Corporate Veil

When a corporation owns a subsidiary corporation, the question frequently arises whether the subsidiary is acting as an independent entity (see Figure 21.2). The Supreme Court addressed this question of derivative versus direct liability of the corporate parent vis-à-vis its subsidiary in *United States v. Bestfoods*, (see Section 21.7.2 "Piercing the Corporate Veil").

Other Types of Personal Liability

Even when a corporation is formed for a proper purpose and is operated as a corporation, there are instances in which individual shareholders will be personally liable. For example, if a shareholder involved in company management commits a tort or enters into a contract in a personal capacity, he will remain personally liable for the consequences of his actions. In some states, statutes give employees special rights against shareholders. For example, a New York statute permits employees to recover wages, salaries, and debts owed them by the company from the ten largest shareholders of the corporation. (Shareholders of public companies

whose stock is traded on a national exchange or over the counter are exempt.) Likewise, federal law permits the IRS to recover from the “responsible persons” any withholding taxes collected by a corporation but not actually paid over to the US Treasury.

Key Takeaway

Corporations have some of the legal rights of a natural person. They are entitled to the constitutional protections of due process and equal protection, Fourth Amendment protection against unreasonable search and seizure, and First Amendment protection of free speech and expression. For purposes of the federal courts’ diversity jurisdiction, a corporation is deemed to be a citizen of both the state in which it is incorporated and the state in which it has its principal place of business. However, corporations do not have the privilege against self-incrimination guaranteed for natural persons by the Fifth and Fourteenth Amendments. Further, corporations are not free from liability. Courts will pierce the corporate veil and hold a corporation liable when the corporation is used to perpetrate fraud or when it fails to act as a corporation.

Exercises

1. Do you think that corporations should have rights similar to those of natural persons? Should any of these rights be curtailed?
2. What is an example of speaking the “corporate mind”?
3. If Corporation BCD’s president and majority stockholder secretly sells all of his stock before resigning a few days later, and the corporation’s unexpected change in majority ownership causes the share price to plummet, do corporate stockholders have a cause of action? If so, under what theory?

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13.4: Classifications of Corporations

Learning Objectives

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

- Distinguish the "public," or municipal, corporation from the publicly held corporation.
- Explain how the tax structure for professional corporations evolved.
- Define the two types of business corporations.

Nonprofit Corporations

One of the four major classifications of corporations is the nonprofit corporation (also called not-for-profit corporation). It is defined in the American Bar Association's Model Non-Profit Corporation Act as "a corporation no part of the income of *which* is distributable to its members, directors or officers." Nonprofit corporations may be formed under this law for charitable, educational, civil, religious, social, and cultural purposes, among others. Note: this does not mean a nonprofit corporation cannot make more money that it spends. In fact, to be a viable business nonprofits ordinarily must have revenue that exceeds expenses over the long term. Otherwise, how else could a nonprofit like the American Red Cross have over $4 billion (as of 2024) in assets? Unlike a for-profit corporation, nonprofits cannot distribute its assets (by way of, for instance, dividends) to its members, directors, or officers.

Public Corporations

The true public corporation is a governmental entity. It is often called a municipal corporation, to distinguish it from the publicly held corporation, which is sometimes also referred to as a "public" corporation, although it is in fact private (i.e., it is not governmental). Major cities and counties, and many towns, villages, and special governmental units, such as sewer, transportation, and public utility authorities, are incorporated. These corporations are not organized for profit, do not have shareholders, and operate under different statutes than do business corporations.

Professional Corporations

Until the 1960s, lawyers, doctors, accountants, and other professionals could not practice their professions in corporate form. This inability, based on a fear of professionals' being subject to the direction of the corporate owners, was financially disadvantageous. Under the federal income tax laws then in effect, corporations could establish far better pension plans than could the self-employed. During the 1960s, the states began to let professionals incorporate, but the IRS balked, denying them many tax benefits. In 1969, the IRS finally conceded that it would tax a professional corporation just as it would any other corporation, so that professionals could, from that time on, place a much higher proportion of tax-deductible income into a tax-deferred pension. That decision led to a burgeoning number of professional corporations.

Business Corporations

The Two Types

It is the business corporation proper that we focus on in this unit. There are two broad types of business corporations: publicly held (or public) and closely held (or close or private) corporations. Again, both types are private in the sense that they are not governmental.

The publicly held corporation is one in which stock is widely held or available for wide public distribution through such means as trading on a national or regional stock exchange. Its managers, if they are also owners of stock, usually constitute a small percentage of the total number of shareholders and hold a small amount of stock relative to the total shares outstanding. Few, if any, shareholders of public corporations know their fellow shareholders.

By contrast, the shareholders of the closely held corporation are fewer in number. Shares in a closely held corporation could be held by one person, and usually by no more than thirty. Shareholders of the closely held corporation often share family ties or have some other association that permits each to know the others.

Though most closely held corporations are small, no economic or legal reason prevents them from being large. Some are huge, having annual sales of several billion dollars each. Roughly 90 percent of US corporations are closely held.

The giant publicly held companies with more than $100 billion in annual revenue, such as Amazon or UnitedHealth Group, constitute an exclusive group. Publicly held corporations outside this elite class fall into two broad (nonlegal) categories: those that are quoted on stock exchanges and those whose stock *is* too widely dispersed to be called closely held but is not traded on exchanges.

Key Takeaway

There are four major classifications of corporations: (1) nonprofit, (2) municipal, (3) professional, and (4) business. Business corporations are divided into two types, publicly held and closely held corporations.

Exercises

1. Why did professionals, such as doctors, lawyers, and accountants, wait so long to incorporate?
2. Distinguish a publicly held corporation from a closely held one.
3. Are most corporations in the US publicly or closely held? Are closely held corporations subject to different provisions than publicly held ones?

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13.5: Corporate Organization

Learning Objectives

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

- Recognize the steps to issue a corporate charter.
- Know the states' rights in modifying a corporate charter.
- Discuss factors to consider in selecting a state in which to incorporate.
- Explain the functions and liability of a promoter.
- Understand the business and legal requirements in executing and filing the articles of incorporation.

Corporate status offers companies many protections. If the owners of a business decide to incorporate after weighing the pros and cons of incorporation, they need to take the steps explained in this section.

The Corporate Charter

Function of the Charter

The ultimate goal of the incorporation process is issuance of a corporate charter. The term used for the document varies from state to state. Most states call the basic document filed in the appropriate public office the "articles of incorporation" or "certificate of incorporation," but there are other variations. There is no legal significance to these differences in terminology.

Chartering is basically a state prerogative. Congress has chartered several enterprises, including national banks (under the National Banking Act), federal savings and loan associations, national farm loan associations, and the like, but virtually all business corporations are chartered at the state level.

Originally a legislative function, chartering is now an administrative function in every state. The secretary of state issues the final endorsement to the articles of incorporation, thus giving them legal effect.

Charter as a Contract

The charter is a contract between the state and the corporation. Under the Contracts Clause of Article I of the Constitution, no state can pass any law "impairing the obligation of contracts." In 1816, the question arose whether a state could revoke or amend a corporate charter once granted. The corporation in question was Dartmouth College. The New Hampshire legislature sought to turn the venerable private college, operating under an old royal charter, into a public institution by changing the membership of its board. The case wound up in the Supreme Court. Chief Justice John Marshall ruled that the legislature's attempt was unconstitutional, because to amend a charter is to impair a contract. (*Trustees of Dartmouth College v. Woodward*, 17 U.S. 518 (1819).)

This decision pleased incorporators because it implied that once a corporation had been created, the state could never modify the powers it had been granted. But, in addition, the ruling seemed to favor monopolies. The theory was that by granting a charter to, say, a railroad corporation, the state was barred from creating any further railroad corporations. Why? Because, the lawyers argued, a competitor would cut into the first company's business, reducing the value of the charter, hence impairing the contract. Justice Joseph Story, concurring in the *Dartmouth* case, had already suggested the way out for the states: "If the legislature mean to claim such an authority [to alter or amend the charter], it must be reserved in the grant. The charter of Dartmouth College contains no such reservation.…" The states quickly picked up on Justice Story's suggestion and wrote into the charter explicit language giving legislatures the authority to modify corporations' charters at their pleasure. So the potential immutability of corporate charters had little practical chance to develop.

Selection of a State

Where to Charter

Choosing the particular venue in which to incorporate is the first critical decision to be made after deciding to incorporate. Some corporations, though headquartered in the United States, choose to incorporate offshore to take advantage of lenient taxation laws.

Advantages of an offshore corporation include not only lenient tax laws but also a great deal of privacy as well as certain legal protections. For example, the names of the officers and directors can be excluded from documents filed. In the United States, over half of the *Fortune* 500 companies hold Delaware charters for reasons related to Delaware's having a lower tax structure, a favorable business climate, and a legal system—both its statutes and its courts—seen as being up to date, flexible, and often probusiness. Delaware's success has led other states to compete, and the political realities have caused the Revised Model Business Corporation Act (RMBCA), which was intentionally drafted to balance the interests of all significant groups (management, shareholders, and the public), to be revised from time to time so that it is more permissive from the perspective of management.

Why Choose Delaware?

Delaware remains the most popular state in which to incorporate for several reasons, including the following: (1) low incorporation fees; (2) only one person is needed to serve the incorporator of the corporation; the RMBC requires three incorporators; (3) no minimum capital requirement; (4) favorable tax climate, including no sales tax; (5) no taxation of shares held by nonresidents; and (5) no corporate income tax for companies doing business outside of Delaware. In addition, Delaware's Court of Chancery, a court of equity, is renowned as a premier business court with a well-established body of corporate law, thereby affording a business a certain degree of predictability in judicial decision making.

The Promoter

Once the state of incorporation has been selected, it is time for promoters, the midwives of the enterprise, to go to work. Promoters are the individuals who take the steps necessary to form the corporation, and they often will receive stock in exchange for their efforts. They have four principal functions: (1) to seek out or discover business opportunities, (2) to raise capital by persuading investors to sign stock subscriptions, (3) to enter into contracts on behalf of the corporation to be formed, (4) and to prepare the articles of incorporation.

Promoters have acquired an unsavory reputation as fast talkers who cajole investors out of their money. Though some promoters fit this image, it is vastly overstated. Promotion is difficult work often carried out by the same individuals who will manage the business.

Execution and Filing of the Articles of Incorporation

Once the business details are settled, the promoters, now known as incorporators, must sign and deliver the articles of incorporation to the secretary of state. The articles of incorporation typically include the following: the corporate name; the address of the corporation's initial registered office; the period of the corporation's duration (usually perpetual); the company's purposes; the total number of shares, the classes into which they are divided, and the par value of each; the limitations and rights of each class of shareholders; the authority of the directors to establish preferred or special classes of stock; provisions for preemptive rights; provisions for the regulation of the internal affairs of the corporation, including any provision restricting the transfer of shares; the number of directors constituting the initial board of directors and the names and addresses of initial members; and the name and address of each incorporator. Although compliance with these requirements is largely a matter of filling in the blanks, two points deserve mention.

First, the choice of a name is often critical to the business. Under RMBCA, Section 4.01, the name must include one of the following words (or abbreviations): corporation, company, incorporated, or limited (Corp., Co., Inc., or Ltd.). The name is not allowed to deceive the public about the corporation's purposes, nor may it be the same as that of any other company incorporated or authorized to do business in the state.

These legal requirements are obvious; the business requirements are much harder. If the name is not descriptive of the business or does not anticipate changes in the business, it may have to be changed, and the change can be expensive. For example, when Standard Oil Company of New Jersey changed its name to Exxon in 1972, the estimated cost was over $100 million. (And even with this expenditure, some shareholders grumbled that the new name sounded like a laxative.)

The second point to bear in mind about the articles of incorporation is that drafting the clause stating corporate purposes requires special care, because the corporation will be limited to the purposes set forth. In one famous case, the charter of Cornell University placed a limit on the amount of contributions it could receive from any one benefactor. When Jennie McGraw died in 1881, leaving to Cornell the carillon that still plays on the Ithaca, New York, campus to this day, she also bequeathed to the university her

residuary estate valued at more than $1 million. This sum was greater than the ceiling placed in Cornell's charter. After lengthy litigation, the university lost in the US Supreme Court, and the money went to her family. (*Cornell University v. Fiske*, 136 U.S. 152 (1890).) The dilemma is how to draft a clause general enough to allow the corporation to expand, yet specific enough to prevent it from engaging in undesirable activities.

Some states require the purpose clauses to be specific, but the usual approach is to permit a broad statement of purposes. Section 3.01 of the RMBCA goes one step further in providing that a corporation automatically "has the purpose of engaging in any lawful business" unless the articles specify a more limited purpose. Once completed, the articles of incorporation are delivered to the secretary of state for filing. The existence of a corporation begins once the articles have been filed.

Organizational Meeting of Directors

The first order of business, once the certificate of incorporation is issued, is a meeting of the board of directors named in the articles of incorporation. The board of directors governs the corporation and is its ultimate decider--it is in charge. They must adopt bylaws, elect officers, and transact any other business that may come before the meeting (RMBCA, Section 2.05). Other business would include accepting (ratifying) promoters' contracts, calling for the payment of stock subscriptions, and adopting bank resolution forms, giving authority to various officers to sign checks drawn on the corporation.

Section 10.20 of the RMBCA vests in the directors the power to alter, amend, or repeal the bylaws adopted at the initial meeting, subject to repeal or change by the shareholders. The articles of incorporation may reserve the power to modify or repeal exclusively to the shareholders. The bylaws may contain any provisions that do not conflict with the articles of incorporation or the law of the state.

Typical provisions in the bylaws include fixing the place and time at which annual stockholders' meetings will be held, fixing a quorum, setting the method of voting, establishing the method of choosing directors, creating committees of directors, setting down the method by which board meetings may be called and the voting procedures to be followed, determining the offices to be filled by the directors and the powers with which each officer shall be vested, fixing the method of declaring dividends, establishing a fiscal year, setting out rules governing issuance and transfer of stock, and establishing the method of amending the bylaws.

Section 2.07 of the RMBCA provides that the directors may adopt bylaws that will operate during an emergency. An emergency is a situation in which "a quorum of the corporation's directors cannot readily be assembled because of some catastrophic event."

Key Takeaway

Articles of incorporation represent a corporate charter—that is, a contract between the corporation and the state. Filing these articles, or "chartering," is accomplished at the state level. The secretary of state's final approval gives these articles legal effect. A state cannot change a charter unless it reserves the right when granting the charter.

In selecting a state in which to incorporate, a corporation looks for a favorable corporate climate. Delaware remains the state of choice for incorporation, particularly for publicly held companies. Most closely held companies choose to incorporate in their home states.

Following the state selection, the promoter commences his or her functions, which include entering into contracts on behalf of the corporation to be formed (for which he or she can be held liable) and preparing the articles of incorporation.

The articles of incorporation must include the corporation's name and its corporate purpose, which can be broad. Finally, once the certificate of incorporation is issued, the corporation's board of directors must hold an organizational meeting.

Exercises

1. Does the Contracts Clause of the Constitution, which forbids a state from impeding a contract, apply to corporations?
2. What are some of the advantages of selecting Delaware as the state of incorporation?
3. What are some of the risks that a promoter faces for his or her actions on behalf of the corporation? Can he or she limit these risks?
4. What are the dangers of limiting a corporation's purpose?
5. What is the order of business at the first board of directors' meeting?

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13.6: Summary and Exercises

Summary

The hallmark of the corporate form of business enterprise is limited liability for its owners. Other features of corporations are separation of ownership and management, perpetual existence, and easy transferability of interests. In the early years of the common law, corporations were thought to be creatures of sovereign power and could be created only by state grant. But by the late nineteenth century, corporations could be formed by complying with the requirements of general corporation statutes in virtually every state. Today the standard is the Revised Model Business Corporation Act.

The corporation, as a legal entity, has many of the usual rights accorded natural persons. The principle of limited liability is broad but not absolute: when the corporation is used to commit a fraud or an injustice or when the corporation does not act as if it were one, the courts will pierce the corporate veil and pin liability on stockholders.

Besides the usual business corporation, there are other forms, including not-for-profit corporations and professional corporations. Business corporations are classified into two types: publicly held and closely held corporations.

To form a corporation, the would-be stockholders must choose the state in which they wish to incorporate. The goal of the incorporation process is issuance of a corporate charter. The charter is a contract between the state and the corporation. Although the Constitution prohibits states from impairing the obligation of contracts, states reserve the right to modify corporate charters.

The corporation is created by the incorporators (or promoters), who raise capital, enter into contracts on behalf of the corporation to be formed, and prepare the articles of incorporation. The promoters are personally liable on the contracts they enter into before the corporation is formed. Incorporators owe a fiduciary duty to each other, to investors, and to the corporation.

The articles of incorporation typically contain a number of features, including the corporate name, corporate purposes, total number of shares and classes into which they are divided, par value, and the like. The name must include one of the following words (or abbreviations): corporation, company, incorporated, or limited (Corp., Co., Inc., or Ltd.). The articles of incorporation must be filed with the secretary of state. Once they have been filed, the board of directors named in the articles must adopt bylaws, elect officers, and conduct other necessary business. The directors are empowered to alter the bylaws, subject to repeal or change by the shareholders.

Exercises

1. Two young business school graduates, Laverne and Shirley, form a consulting firm. In deciding between the partnership and corporation form of organization, they are especially concerned about personal liability for giving bad advice to their clients; that is, in the event they are sued, they want to prevent plaintiffs from taking their personal assets to satisfy judgments against the firm. Which form of organization would you recommend? Why?
2. Assume that Laverne and Shirley in Exercise 1 must negotiate a large loan from a local bank in order to finance their firm. A friend advises them that they should incorporate in order to avoid personal liability for the loan. Is this good advice? Why?
3. Assume that Laverne and Shirley decide to form a corporation. Before the incorporation process is complete, Laverne enters into a contract on behalf of the corporation to purchase office furniture and equipment for $20,000. After the incorporation process has been completed, the corporation formally accepts the contract made by Laverne. Is Laverne personally liable on the contract before corporate acceptance? After corporate acceptance? Why?
4. Assume that Laverne and Shirley have incorporated their business. One afternoon, an old college friend visits Shirley at the office. Shirley and her friend decide to go out for dinner to discuss old times. Shirley, being short of cash, takes money from a petty cash box to pay for dinner. (She first obtains permission from Laverne, who has done the same thing many times in the past.) Over dinner, Shirley learns that her friend is now an IRS agent and is investigating Shirley's corporation. What problems does Shirley face in the investigation? Why?
5. Assume that Laverne and Shirley prepare articles of incorporation but forget to send the articles to the appropriate state office. A few months after they begin to operate their consulting business as a corporation, Laverne visits a client. After her meeting, in driving out of a parking lot, Laverne inadvertently backs her car over the client, causing serious bodily harm. Is Shirley liable for the accident? Why?

6. Ralph, a resident of Oklahoma, was injured when using a consumer product manufactured by a corporation whose principal offices were in Tulsa. Since his damages exceeded $10,000, he filed a products-liability action against the company, which was incorporated in Delaware, in federal court. Does the federal court have jurisdiction? Why?
7. Alice is the president and only shareholder of a corporation. The IRS is investigating Alice and demands that she produce her corporate records. Alice refuses, pleading the Fifth Amendment privilege against self-incrimination. May the IRS force Alice to turn over her corporate records? Why?

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CHAPTER OVERVIEW

14: Securities Regulation

Learning Objectives

After reading this chapter, you should understand the following:

- The nature of securities regulation
- The Securities Act of 1933 and the Securities Exchange Act of 1934
- Liability under securities laws
- What insider trading is and why it's unlawful
- Civil and criminal penalties for violations of securities laws

Both the registration and the trading of securities are highly regulated by the Securities and Exchange Commission (SEC). A violation of a securities law can lead to severe criminal and civil penalties. But first we examine the question, Why is there a need for securities regulation?

14.1: The Nature of Securities Regulation

14.2: Liability under Securities Law

14.3: Summary and Exercises

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14.1: The Nature of Securities Regulation

Learning Objectives

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

- Recognize that the definition of *security* encompasses a broad range of interests.
- Understand the functions of the Securities and Exchange Commission and the penalties for violations of the securities laws.
- Understand which companies the Securities Exchange Act of 1934 covers.
- Explore the purpose of state Blue Sky Laws.
- Know the basic provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

What we commonly refer to as "**securities**" are essentially worthless pieces of paper. Their inherent value lies in the interest in property or an ongoing enterprise that they represent. This disparity between the tangible property—the stock certificate, for example—and the intangible interest it represents gives rise to several reasons for regulation. First, there is need for a mechanism to inform the buyer accurately what it is he is buying. Second, laws are necessary to prevent and provide remedies for deceptive and manipulative acts designed to defraud buyers and sellers. Third, the evolution of stock trading on a massive scale has led to the development of numerous types of specialists and professionals, in dealings with whom the public can be at a severe disadvantage, and so the law undertakes to ensure that they do not take unfair advantage of their customers.

The **Securities Act of 1933** and the **Securities Exchange Act of 1934** are two federal statutes that are vitally important, having virtually refashioned the law governing corporations during the past half century. In fact, it is not too much to say that although they deal with securities, they have become the general federal law of corporations. This body of federal law has assumed special importance in recent years as the states have engaged in a race to the bottom in attempting to compete with Delaware's permissive corporation law.

What Is a Security?

Securities law questions are technical and complex and usually require professional counsel. For the nonlawyer, the critical question on which all else turns is whether the particular investment or document is a security. If it is, anyone attempting any transaction beyond the routine purchase or sale through a broker should consult legal counsel to avoid the various civil and criminal minefields that the law has strewn about.

The definition of *security*, which is set forth in the Securities Act of 1933, is comprehensive, but it does not on its face answer all questions that financiers in a dynamic market can raise. Under Section 2(1) of the act, "security" includes "any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

Under this definition, an investment may not be a security even though it is so labeled, and it may actually be a security even though it is called something else. For example, does a service contract that obligates someone who has sold individual rows in an orange orchard to cultivate, harvest, and market an orange crop involve a security subject to regulation under federal law? Yes, said the Supreme Court in *Securities & Exchange Commission v. W. J. Howey Co.Securities & Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293 (1946). The Court said the test is whether "the person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." Under this test, courts have liberally interpreted "investment contract" and "certificate of interest or participation in any profit-sharing agreement" to be securities interests in such property as real estate condominiums and cooperatives, commodity option contracts, and farm animals.

The Securities and Exchange Commission

Functions

The Securities and Exchange Commission (SEC) is over half a century old, having been created by Congress in the Securities Exchange Act of 1934. It is an independent regulatory agency, subject to the rules of the Administrative Procedure Act (see Chapter 5). The commission is composed of five members, who have staggered five-year terms. Every June 5, the term of one of the commissioners expires. Although the president cannot remove commissioners during their terms of office, he does have the power to designate the chairman from among the sitting members. The SEC is bipartisan: not more than three commissioners may be from the same political party.

The SEC's primary task is to investigate complaints or other possible violations of the law in securities transactions and to bring enforcement proceedings when it believes that violations have occurred. It is empowered to conduct information inquiries, interview witnesses, examine brokerage records, and review trading data. If its requests are refused, it can issue subpoenas and seek compliance in federal court. Its usual leads come from complaints of investors and the general public, but it has authority to conduct surprise inspections of the books and records of brokers and dealers. Another source of leads is price fluctuations that seem to have been caused by manipulation rather than regular market forces.

Among the violations the commission searches out are these: (1) unregistered sale of securities subject to the registration requirement of the Securities Act of 1933, (2) fraudulent acts and practices, (3) manipulation of market prices, (4) carrying out of a securities business while insolvent, (5) misappropriation of customers' funds by brokers and dealers, and (4) other unfair dealings by brokers and dealers.

When the commission believes that a violation has occurred, it can take one of three courses. First, it can refer the case to the Justice Department with a recommendation for criminal prosecution in cases of fraud or other willful violation of law.

Second, the SEC can seek a civil injunction in federal court against further violations. As a result of amendments to the securities laws in 1990 (the Securities Enforcement Remedies and Penny Stock Reform Act), the commission can also ask the court to impose civil penalties. The maximum penalty is $100,000 for each violation by a natural person and $500,000 for each violation by an entity other than a natural person. Alternatively, the defendant is liable for the gain that resulted from violating securities law if the gain exceeds the statutory penalty. The court is also authorized to bar an individual who has committed securities fraud from serving as an officer or a director of a company registered under the securities law.

Third, the SEC can proceed administratively—that is, hold its own hearing, with the usual due process rights, before an administrative law judge. If the commissioners by majority vote accept the findings of the administrative law judge after reading briefs and hearing oral argument, they can impose a variety of sanctions: suspend or expel members of exchanges; deny, suspend, or revoke the registrations of broker-dealers; censure individuals for misconduct; and bar censured individuals (temporarily or permanently) from employment with a registered firm. The 1990 securities law amendments allow the SEC to impose civil fines similar to the court-imposed fines described. The amendments also authorize the SEC to order individuals to cease and desist from violating securities law.

Fundamental Mission

The SEC's fundamental mission is to ensure adequate disclosure in order to facilitate informed investment decisions by the public. However, whether a particular security offering is worthwhile or worthless is a decision for the public, not for the SEC, which has no legal authority to pass on the merits of an offering or to bar the sale of securities if proper disclosures are made.

One example of SEC's regulatory mandate with respect to disclosures involved the 1981 sale of $274 million in limited partnership interests in a company called Petrogene Oil & Gas Associates, New York. The Petrogene offering was designed as a tax shelter. The company's filing with the SEC stated that the offering involved "a high degree of risk" and that only those "who can afford the complete loss of their investment" should contemplate investing. Other disclosures included one member of the controlling group having spent four months in prison for conspiracy to commit securities fraud; that he and another principal were the subject of a New Mexico cease and desist order involving allegedly unregistered tax-sheltered securities; that the general partner, brother-in-law of one of the principals, had no experience in the company's proposed oil and gas operations (Petrogene planned to extract oil from plants by using radio frequencies); that one of the oils to be produced was potentially carcinogenic; and that the principals "stand to benefit substantially" whether or not the company fails and whether or not purchasers of shares recovered any of their investment. The prospectus went on to list specific risks. Despite this daunting compilation of troublesome details, the SEC

permitted the offering because all disclosures were made (*Wall Street Journal*, December 29, 1981). It is the business of the marketplace, not the SEC, to determine whether the risk is worth taking.

The SEC enforces securities laws through two primary federal acts: The Securities Act of 1933 and The Securities Exchange Act of 1934.

Securities Act of 1933

Goals

The Securities Act of 1933 is the fundamental "truth in securities" law. Its two basic objectives, which are written in its preamble, are "to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof."

Registration

The primary means for realizing these goals is the requirement of registration. Before securities subject to the act can be offered to the public, the issuer must file a registration statement and prospectus with the SEC, laying out in detail relevant and material information about the offering as set forth in various schedules to the act. If the SEC approves the registration statement, the issuer must then provide any prospective purchaser with the prospectus. Since the SEC does not pass on the fairness of price or other terms of the offering, it is unlawful to state or imply in the prospectus that the commission has the power to disapprove securities for lack of merit, thereby suggesting that the offering is meritorious.

The SEC has prepared special forms for registering different types of issuing companies. All call for a description of the registrant's business and properties and of the significant provisions of the security to be offered, facts about how the issuing company is managed, and detailed financial statements certified by independent public accountants.

Once filed, the registration and prospectus become public and are open for public inspection. Ordinarily, the effective date of the registration statement is twenty days after filing. Until then, the offering may not be made to the public. Section 2(10) of the act defines *prospectus* as any "notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security." (An exception: brief notes advising the public of the availability of the formal prospectus.) The import of this definition is that any communication to the public about the offering of a security is unlawful unless it contains the requisite information.

The SEC staff examines the registration statement and prospectus, and if they appear to be materially incomplete or inaccurate, the commission may suspend or refuse the effectiveness of the registration statement until the deficiencies are corrected. Even after the securities have gone on sale, the agency has the power to issue a stop order that halts trading in the stock.

Section 5(c) of the act bars any person from making any sale of any security unless it is first registered. Nevertheless, there are certain classes of exemptions from the registration requirement. Perhaps the most important of these is Section 4(3), which exempts "transactions by any person other than an issuer, underwriter or dealer." Section 4(3) also exempts most transactions of dealers. So the net is that trading in outstanding securities (the secondary market) is exempt from registration under the Securities Act of 1933: you need not file a registration statement with the SEC every time you buy or sell securities through a broker or dealer, for example.

Penalties

Section 24 of the Securities Act of 1933 provides for fines not to exceed $10,000 and a prison term not to exceed five years, or both, for willful violations of any provisions of the act. This section makes these criminal penalties specifically applicable to anyone who "willfully, in a registration statement filed under this title, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading."

Sections 11 and 12 provide that anyone injured by false declarations in registration statements, prospectuses, or oral communications concerning the sale of the security—as well as anyone injured by the unlawful failure of an issuer to register—may file a civil suit to recover the net consideration paid for the security or for damages if the security has been sold.

Securities Exchange Act of 1934

The Securities Act of 1933 is limited, as we have just seen, to new securities issues—that is the primary market. The trading that takes place in the secondary market is far more significant, however. In a normal year, trading in outstanding stock totals some twenty times the value of new stock issues.

To regulate the secondary market, Congress enacted the Securities Exchange Act of 1934. This law, which created the SEC, extended the disclosure rationale to securities listed and registered for public trading on the national securities exchanges. Amendments to the act have brought within its ambit every corporation whose equity securities are traded over the counter if the company has at least $10 million in assets and five hundred or more shareholders.

Blue Sky Laws

Long before congressional enactment of the securities laws in the 1930s, the states had legislated securities regulations. Today, every state has enacted a blue sky law, so called because its purpose is to prevent "speculative schemes which have no more basis than so many feet of 'blue sky.'" (*Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917).) The federal Securities Act of 1933, discussed in Section 24.1.3 "Securities Act of 1933", specifically preserves the jurisdiction of states over securities.

Blue sky laws are divided into three basic types of regulation. The simplest is that which prohibits fraud in the sale of securities. Thus at a minimum, issuers cannot mislead investors about the purpose of the investment. All blue sky laws have antifraud provisions; some have no other provisions. The second type calls for registration of broker-dealers, and the third type for registration of securities. Some state laws parallel the federal laws in intent and form of proceeding, so that they overlap; other blue sky laws empower state officials (unlike the SEC) to judge the merits of the offerings, often referred to as merit review laws. As part of a movement toward deregulation, several states have recently modified or eliminated merit provisions.

Dodd-Frank Wall Street Reform and Consumer Protection Act

In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, which is the largest amendment to financial regulation in the United States since the Great Depression. This amendment was enacted in response to the economic recession of the late 2000s for the following purposes: (1) to promote the financial stability of the United States by improving accountability and transparency in the financial system, (2) to end "too big to fail" institutions, (3) to protect the American taxpayer by ending bailouts, and (4) to protect consumers from abusive financial services practices. The institutions most affected by the regulatory changes include those involved in monitoring the financial system, such as the Federal Deposit Insurance Corporation (FDIC) and the SEC. Importantly, the amendment ended the exemption for investment advisors who previously were not required to register with the SEC because they had fewer than fifteen clients during the previous twelve months and did not hold out to the public as investment advisors. This means that in practice, numerous investment advisors, as well as hedge funds and private equity firms, are now subject to registration requirements.

Key Takeaway

The SEC administers securities laws to prevent the fraudulent practices in the sales of securities. The definition of *security* is intentionally broad to protect the public from fraudulent investments that otherwise would escape regulation. The Securities Act of 1933 focuses on the issuance of securities, and the Securities Exchange Act of 1934 deals predominantly with trading in issued securities. Numerous federal and state securities laws are continuously created to combat securities fraud, with penalties becoming increasingly severe.

Exercises

1. What differentiates an ordinary investment from a security? List all the factors.
2. What is the main objective of the SEC?
3. What are the three courses of action that the SEC may take against one who violates a securities law?
4. What is the difference between the Securities Act of 1933 and the Securities Exchange Act of 1934?
5. What do blue sky laws seek to protect?

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14.2: Liability under Securities Law

Learning Objectives

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

- Understand how the Foreign Corrupt Practices Act prevents American companies from using bribes to enter into contracts or gain licenses from foreign governments.
- Understand the liability for insider trading for corporate insiders, "tippees," and secondary actors under Sections 16(b) and 10(b) of the 1934 Securities Exchange Act.
- Recognize how the Sarbanes-Oxley Act has amended the 1934 act to increase corporate regulation, transparency, and penalties.

Corporations may be found liable if they engage in certain unlawful practices, several of which we explore in this section.

The Foreign Corrupt Practices Act

Investigations by the Securities and Exchange Commission (SEC) and the Watergate Special Prosecutor in the early 1970s turned up evidence that hundreds of companies had misused corporate funds, mainly by bribing foreign officials to induce them to enter into contracts with or grant licenses to US companies. Because revealing the bribes would normally be self-defeating and, in any event, could be expected to stir up immense criticism, companies paying bribes routinely hid the payments in various accounts. As a result, one of many statutes enacted in the aftermath of Watergate, the Foreign Corrupt Practices Act (FCPA) of 1977, was incorporated into the 1934 Securities Exchange Act. The SEC's legal interest in the matter is not premised on the morality of bribery but rather on the falsity of the financial statements that are being filed.

Congress's response to abuses of financial reporting, the FCPA, was much broader than necessary to treat the violations that were uncovered. The FCPA prohibits an issuer (i.e., any US business enterprise), a stockholder acting on behalf of an issuer, and "any officer, director, employee, or agent" of an issuer from using either the mails or interstate commerce corruptly to offer, pay, or promise to pay anything of value to foreign officials, foreign political parties, or candidates if the purpose is to gain business by inducing the foreign official to influence an act of the government to render a decision favorable to the US corporation.

Insider Trading

Corporate insiders—directors, officers, or important shareholders—can have a substantial trading advantage if they are privy to important confidential information. Learning bad news (such as financial loss or cancellation of key contracts) in advance of all other stockholders will permit the privileged few to sell shares before the price falls. Conversely, discovering good news (a major oil find or unexpected profits) in advance gives the insider a decided incentive to purchase shares before the price rises.

The Securities Exchange Act assumes that any director, officer, or shareholder owning 10 percent or more of the stock in a corporation is using inside information if he or any family member makes a profit from trading activities, either buying and selling or selling and buying, during a six-month period. Section 16(b) penalizes any such person by permitting the corporation or a shareholder suing on its behalf to recover the short-swing profits. The law applies to any company with more than $10 million in assets and at least five hundred or more shareholders of any class of stock.

Suppose that on January 1, Bob (a company officer) purchases one hundred shares of stock in BCT Bookstore, Inc., for $60 a share. On September 1, he sells them for $100 a share. What is the result? Bob is in the clear, because his $4,000 profit was not realized during a six-month period. Now suppose that the price falls, and one month later, on October 1, he repurchases one hundred shares at $30 a share and holds them for two years. What is the result? He will be forced to pay back $7,000 in profits even if he had no inside information. Why? In August, Bob held one hundred shares of stock, and he did again on October 1—within a six-month period. His net gain on these transactions was $7,000 ($10,000 realized on the sale less the $3,000 cost of the purchase).

Section 10(b) of the Securities Exchange Act of 1934 prohibits any person from using the mails or facilities of interstate commerce "to use or employ, in connection with the purchase or sale of any security…any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." In 1942, the SEC learned of a company president who misrepresented the company's financial

condition in order to buy shares at a low price from current stockholders. So the commission adopted a rule under the authority of Section 10(b). Rule 10b-5, as it was dubbed, has remained unchanged for more than forty years and has spawned thousands of lawsuits and SEC proceedings. It reads as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Rule 10b-5 applies to any person who purchases or sells any security. It is not limited to securities registered under the 1934 Securities Exchange Act. It is not limited to publicly held companies. It applies to any security issued by any company, including the smallest closely held company. In substance, it is an antifraud rule, enforcement of which seems, on its face, to be limited to action by the SEC. But over the years, the courts have permitted people injured by those who violate the statute to file private damage suits. This sweeping rule has at times been referred to as the "federal law of corporations" or the "catch everybody" rule.

Congress had been concerned about insider trading, and in 1984 and 1988, it substantially increased the penalties. A person convicted of insider trading now faces a maximum criminal fine of $1 million and a possible ten-year prison term. A civil penalty of up to three times the profit made (or loss avoided) by insider trading can also be imposed. This penalty is in addition to liability for profits made through insider trading. For example, financier Ivan Boesky, who was sentenced in 1987 to a three-year prison term for insider trading, was required to disgorge $50 million of profits and was liable for another $50 million as a civil penalty. In 2003, Martha Stewart was indicted on charges of insider trading but was convicted for obstruction of justice, serving only five months. More recently, in 2009, billionaire founder of the Galleon Group, Raj Rajaratnam, was arrested for insider trading; he was convicted in May 2011 of all 14 counts of insider trading.

Companies that knowingly and recklessly fail to prevent insider trading by their employees are subject to a civil penalty of up to three times the profit gained or loss avoided by insider trading or $1 million, whichever is greater. Corporations are also subject to a criminal fine of up to $2.5 million.

Key Takeaway

Corrupt practices, misuse of corporate funds, and insider trading unfairly benefit the minority and cost the public billions. Numerous federal laws have been enacted to create liability for these bad actors in order to prevent fraudulent trading activities. Both civil and criminal penalties are available to punish those actors who bribe officials or use inside information unlawfully.

Exercises

1. Why is the SEC so concerned with bribery? What does the SEC really aim to prevent through the FCPA?
2. What are short-swing profits?
3. To whom does Section 16(b) apply?
4. Explain how Rule 10b-5 has been amended "on the basis of" insider information.
5. Can a secondary actor (attorney, accountant) be liable for insider trading? What factors must be present?

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14.3: Summary and Exercises

Summary

Beyond state corporation laws, federal statutes—most importantly, the Securities Act of 1933 and the Securities Exchange Act of 1934—regulate the issuance and trading of corporate securities. The federal definition of *security* is broad, encompassing most investments, even those called by other names.

The law does not prohibit risky stock offerings; it bans only those lacking adequate disclosure of risks. The primary means for realizing this goal is the registration requirement: registration statements, prospectuses, and proxy solicitations must be filed with the Securities and Exchange Commission (SEC). Penalties for violation of securities law include criminal fines and jail terms, and damages may be awarded in civil suits by both the SEC and private individuals injured by the violation of SEC rules. A 1977 amendment to the 1934 act is the Foreign Corrupt Practices Act, which prohibits an issuer from paying a bribe or making any other payment to foreign officials in order to gain business by inducing the foreign official to influence his government in favor of the US company. This law requires issuers to keep accurate sets of books reflecting the dispositions of their assets and to maintain internal accounting controls to ensure that transactions comport with management's authorization.

The Securities Exchange Act of 1934 presents special hazards to those trading in public stock on the basis of inside information. One provision requires the reimbursement to the company of any profits made from selling and buying stock during a six-month period by directors, officers, and shareholders owning 10 percent or more of the company's stock. Under Rule 10b-5, the SEC and private parties may sue insiders who traded on information not available to the general public, thus gaining an advantage in either selling or buying the stock. Insiders include company employees.

The Sarbanes-Oxley Act amended the 1934 act, creating more stringent penalties, increasing corporate regulation, and requiring greater transparency.

Exercises

1. Assume that the United States enters into a multilateral treaty with several third-world countries under which then-existing private claims to molybdenum and certain other minerals in the United States are assigned to an international agency for exploitation. When the owner of a US mine continues to dig for ore covered by the treaty, the Justice Department sues to enjoin further mining. What is the result? Why?
2. A foreign government enters into a contract with a US company to provide computer equipment and services for the intelligence arm of its military forces. After the equipment has been supplied, the foreign government refuses to pay. The US company files suit in federal court in the United States, seeking to attach a US bank account owned by the foreign government. The foreign government claims that the US court has no jurisdiction and that even if it does, the government is immune from suit. What is the result?
3. Would the result in Exercise 2 be any different if the US company had maintained its own equipment on a lease basis abroad and the foreign government had then expropriated the equipment and refused to pay the US company its just value?
4. The Concentrated Phosphate Export Association consists of the five largest phosphate producers. The Agency for International Development (AID) undertook to sell fertilizer to Korea and solicited bids. The association set prices and submitted a single bid on 300,000 tons. A paid the contract price, determined the amounts to be purchased, coordinated the procedure for buying, and undertook to resell to Korea. The Justice Department sued the association and its members, claiming that their actions violated Section 1 of the Sherman Act. What defense might the defendants have? What is the result?
5. Canada and Russia have competing claims over fishing and mining rights in parts of the Arctic Ocean. Assuming they cannot settle their competing claims through diplomatic negotiation, where might they have their dispute settled?

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CHAPTER OVERVIEW

15: Antitrust Law

Learning Objectives

After reading this chapter, you should understand the following:

- The history and basic framework of antitrust laws on horizontal restraints of trade
- The distinction between vertical restraints of trade and horizontal restraints of trade
- The various exemptions from antitrust law that Congress has created
- Why monopolies pose a threat to competitive markets, and what kinds of monopolies are proscribed by the Sherman Act and the Clayton Act

This chapter will describe the history and current status of federal laws to safeguard the US market from anticompetitive practices, especially those of very large companies that may have a monopoly. Companies that have a monopoly in any market segment have the potential to exercise monopoly power in ways that are harmful to consumers and competitors. Economic theory assures us that for the most part, competition is good: that sound markets will offer buyers lots of choices and good information about products and services being sold and will present few barriers to entry for buyers and sellers. By encouraging more, rather than fewer, competitors in a given segment of the market, US antitrust law attempts to preserve consumer choice and to limit barriers to entry, yet it does allow some businesses to achieve considerable size and market share on the belief that size can create efficiencies and pass along the benefits to consumers.

15.1: History and Basic Framework of Antitrust Laws in the United States

15.2: Horizontal Restraints of Trade

15.3: Vertical Restraints of Trade

15.4: Exemptions

15.5: Sherman Act, Section 2- Concentrations of Market Power

15.6: Summary and Exercises

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15.1: History and Basic Framework of Antitrust Laws in the United States

Learning Objectives

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

- Know the history and basic framework of antitrust laws in the United States.
- Understand how US antitrust laws may have international application.
- Explain how US antitrust laws are enforced and what kinds of criminal and civil penalties may apply.

In this chapter, we take up the origins of the federal antitrust laws and the basic rules governing restraints of trade.Sherman Act, Section 1; Clayton Act, Section 3. We also look at concentrations of market power: monopoly and acquisitions and mergers.Sherman Act, Section 2; Clayton Act, Section 7.

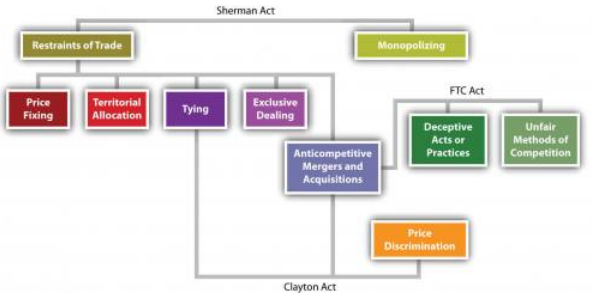


Figure 26.1 An Antitrust Schematic

The antitrust laws are aimed at maintaining competition as the driving force of the US economy. The very word *antitrust* implies opposition to the giant trusts that began to develop after the Civil War. Until then, the economy was largely local; manufacturers, distributors, and retailers were generally small. The Civil War demonstrated the utility of large-scale enterprise in meeting the military's ferocious production demands, and business owners were quick to understand the advantage of size in attracting capital. For the first time, immense fortunes could be made in industry, and adventurous entrepreneurs were quick to do so in an age that lauded the acquisitive spirit.

The first great business combinations were the railroads. To avoid ruinous price wars, railroad owners made private agreements, known as "pools," through which they divided markets and offered discounts to favored shippers who agreed to ship goods on certain lines. The pools discriminated against particular shippers and certain geographic regions, and public resentment grew.

Farmers felt the effects first and hardest, and they organized politically to express their opposition. In time, they persuaded many state legislatures to pass laws regulating railroads. In *Munn v. Illinois*, the Supreme Court rejected a constitutional attack on a state law regulating the transportation and warehousing of grain; the court declared that the "police powers" of the states permit the regulation of property put to public uses. (*Munn v. Illinois*, 94 U.S. 113 (1877).) But over time, many state railroad laws were struck down because they interfered with interstate commerce, which only Congress may regulate constitutionally. The consequence was federal legislation: the Interstate Commerce Act of 1887, establishing the first federal administrative agency, the Interstate Commerce Commission.

In the meantime, the railroads had discovered that their pools lacked enforcement power. Those who nominally agreed to be bound by the pooling arrangement could and often did cheat. The corporate form of business enterprise allowed for potentially immense accumulations of capital to be under the control of a small number of managers; but in the 1870s and 1880s, the corporation was not yet established as the dominant legal form of operation. To overcome these disadvantages, clever lawyers for John D. Rockefeller organized his Standard Oil of Ohio as a common-law *trust*. Trustees were given corporate stock certificates of various companies; by combining numerous corporations into the trust, the trustees could effectively manage and control an entire industry. Within a decade, the Cotton Trust, Lead Trust, Sugar Trust, and Whiskey Trust, along with oil, telephone, steel, and tobacco trusts, had become, or were in the process of becoming, monopolies.

Consumers howled in protest. The political parties got the message: In 1888, both Republicans and Democrats put an antitrust plank in their platforms. In 1889, the new president, Republican Benjamin Harrison, condemned monopolies as "dangerous

conspiracies" and called for legislation to remedy the tendency of monopolies that would "crush out" competition.

The result was the Sherman Antitrust Act of 1890, sponsored by Senator John Sherman of Ohio. Its two key sections forbade combinations in restraint of trade and monopolizing. Senator Sherman and other sponsors declared that the act had roots in a common-law policy that frowned on monopolies. To an extent, it did, but it added something quite important for the future of business and the US economy: the power of the federal government to enforce a national policy against monopoly and restraints of trade. Nevertheless, passage of the Sherman Act did not end the public clamor, because fifteen years passed before a national administration began to enforce the act, when President Theodore Roosevelt—"the Trustbuster"—sent his attorney general after the Northern Securities Corporation, a transportation holding company.

Big business was firmly on the side of regulation, but Congress opted for the policy followed waveringly to the present: competition enforced by government, not a partnership of government and industry, must be the engine of the economy. Accordingly, in 1914, at the urging of President Woodrow Wilson, Congress enacted two more antitrust laws, the Clayton Act and the Federal Trade Commission Act. The Clayton Act outlawed price discrimination, exclusive dealing and tying contracts, acquisition of a company's competitors, and interlocking directorates. The FTC Act outlawed "unfair methods" of competition, established the FTC as an independent administrative agency, and gave it power to enforce the antitrust laws alongside the Department of Justice.

The Sherman, Clayton, and FTC Acts remain the basic texts of antitrust law. Over the years, many states have enacted antitrust laws as well; these laws govern intrastate competition and are largely modeled on the federal laws. The various state antitrust laws are beyond the scope of this textbook.

The Sherman Act

Section 1 of the Sherman Act declares, "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states, or with foreign nations, is declared to be illegal." This is sweeping language. What it embraces seems to depend entirely on the meaning of the words "restraint of trade or commerce." Whatever they might mean, *every* such restraint is declared unlawful. But in fact, as we will see, the proposition cannot be stated quite so categorically, for in 1911 the Supreme Court limited the reach of this section to *unreasonable* restraints of trade.

What does "restraint of trade" mean? The Sherman Act's drafters based the act on a common-law policy against monopolies and other infringements on competition. But common law regarding restraints of trade had been developed in only rudimentary form, and the words have come to mean whatever the courts say they mean. In short, the antitrust laws, and the Sherman Act in particular, authorize the courts to create a federal "common law" of competition.

Section 2 of the Sherman Act prohibits monopolization: "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several states, or with foreign nations, shall be deemed guilty of a misdemeanor." In 1976, Congress upped the ante: violations of the Sherman Act are now felonies. Unlike Section 1, Section 2 does not require a combination between two or more people. A single company acting on its own can be guilty of monopolizing or attempting to monopolize.

The Clayton Act

The Clayton Act was enacted in 1914 to plug what many in Congress saw as loopholes in the Sherman Act. Passage of the Clayton Act was closely linked to that of the FTC Act. Unlike the Sherman Act, the Clayton Act is not a criminal statute; it merely declares certain defined practices as unlawful and leaves it to the government or to private litigants to seek to enjoin those practices. But unlike the FTC Act, the Clayton Act does spell out four undesirable practices. Violations of the Sherman Act require an *actual* adverse impact on competition, whereas violations of the Clayton Act require merely a *probable* adverse impact. Thus the enforcement of the Clayton Act involves a prediction that the defendant must rebut in order to avoid an adverse judgment.

The four types of proscribed behavior are these:

1. Discrimination in prices charged different purchasers of the same commodities.
2. Conditioning the sale of one commodity on the purchaser's refraining from using or dealing in commodities of the seller's competitors.Clayton Act, Section 3.

3. Acquiring the stock of a competing corporation.Clayton Act, Section 7. Because the original language did not prohibit various types of acquisitions and mergers that had grown up with modem corporate law and finance, Congress amended this section in 1950 (the Celler-Kefauver Act) to extend its prohibition to a wide variety of acquisitions and mergers.
4. Membership by a single person on more than one corporate board of directors if the companies are or were competitors.Clayton Act, Section 8.

The Federal Trade Commission Act

Like the Clayton Act, the FTC Act is a civil statute, involving no criminal penalties. Unlike the Clayton Act, its prohibitions are broadly worded. Its centerpiece is Section 5, which forbids "unfair methods of competition in commerce, and unfair or deceptive acts or practices in commerce." We examine Section 5 in Chapter 27.

Enforcement of Antitrust Laws

General Enforcement

There are four different means of enforcing the antitrust laws.

First, the US Department of Justice may bring civil actions to enjoin violations of any section of the Sherman and Clayton Acts and may institute criminal prosecutions for violations of the Sherman Act. Both civil and criminal actions are filed by the offices of the US attorney in the appropriate federal district, under the direction of the US attorney general. In practice, the Justice Department's guidance comes through its Antitrust Division in Washington, headed by an assistant attorney general. With several hundred lawyers and dozens of economists and other professionals, the Antitrust Division annually files fewer than one hundred civil and criminal actions combined. On average, far more criminal cases are filed than civil cases. In 2006, thirty-four criminal cases and twelve civil cases were filed; in 2007, forty criminal cases and six civil cases; in 2008, fifty-four criminal cases and nineteen civil cases; and in 2009, seventy-two criminal cases and nine civil cases.

The number of cases can be less important than the complexity and size of a particular case. For example, *U.S. v. American Telephone & Telegraph* and *U.S. v. IBM* were both immensely complicated, took years to dispose of, and consumed tens of thousands of hours of staff time and tens of millions of dollars in government and defense costs.

Second, the FTC hears cases under the Administrative Procedure Act, as described in Chapter 5. The commission's decisions may be appealed to the US courts of appeals. The FTC may also promulgate "trade regulation rules," which define fair practices in specific industries. The agency has some five hundred lawyers in Washington and a dozen field offices, but only about half the lawyers are directly involved in antitrust enforcement. The government's case against Microsoft was, like the cases against AT&T and IBM, a very complex case that took a large share of time and resources from both the government and Microsoft.

Third, in the Antitrust Improvements Act of 1976, Congress authorized state attorneys general to file antitrust suits in federal court for damages on behalf of their citizens; such a suit is known as a *parens patriae* claim. Any citizen of the state who might have been injured by the defendant's actions may opt out of the suit and bring his or her own private action. The states have long had the authority to file antitrust suits seeking injunctive relief on behalf of their citizens.

Fourth, private individuals and companies may file suits for damages or injunctions if they have been directly injured by a violation of the Sherman or Clayton Act. Private individuals or companies may not sue under the FTC Act, no matter how unfair or deceptive the behavior complained of; only the FTC may do so. In the 1980s, more than 1,500 private antitrust suits were filed in the federal courts each year, compared with fewer than 100 suits filed by the Department of Justice. More recently, the pace is about 250 per year (as of 2023).

Enforcement in International Trade

The Sherman and Clayton Acts apply when a company's activities affect US commerce. This means that these laws apply to US companies that agree to fix the price of goods to be shipped abroad and to the acts of a US subsidiary of a foreign company. It also means that non–US citizens and business entities can be prosecuted for violations of antitrust laws, even if they never set foot in the United States, as long as their anticompetitive activities are aimed at the US market. For example, in November of 2010, a federal grand jury in San Francisco returned an indictment against three former executives in Taiwan. They had conspired to fix prices on color display tubes (CDTs), a type of cathode-ray tube used in computer monitors and other specialized applications.

Criminal Sanctions

Until 1976, violations of the Sherman Act were misdemeanors. The maximum fine was $50,000 for each count on which the defendant was convicted (only $5,000 until 1955), and the maximum jail sentence was one year. But in the CDT case just described, each of the three conspirators was charged with violating the Sherman Act, which carries a maximum penalty of ten years in prison and a $1 million fine for individuals. The maximum fine may be increased to twice the gain derived from the crime or twice the loss suffered by the victims if either of those amounts is greater than the statutory maximum fine of $1 million.

Forfeitures

One provision in the Sherman Act, not much used, permits the government to seize any property in transit in either interstate or foreign commerce if it was the subject of a contract, combination, or conspiracy outlawed under Section 1.

Injunctions and Consent Decrees

The Justice Department may enforce violations of the Sherman and Clayton Acts by seeking injunctions in federal district court. The injunction can be a complex set of instructions, listing in some detail the practices that a defendant is to avoid and even the way in which it will be required to conduct its business thereafter. Once an injunction is issued and affirmed on appeal, or the time for appeal has passed, it confers continuing jurisdiction on the court to hear complaints by those who say the defendant is violating it. In a few instances, the injunction or a consent decree is in effect the basic "statute" by which an industry operates. A 1956 decree against American Telephone & Telegraph Company (AT&T) kept the company out of the computer business for a quarter-century, until the government's monopoly suit against AT&T was settled and a new decree issued in 1983. The federal courts also have the power to break up a company convicted of monopolizing or to order divestiture when the violation consists of unlawful mergers and acquisitions.

The FTC may issue cease and desist orders against practices condemned under Section 5 of the FTC Act—which includes violations of the Sherman and Clayton Acts—and these orders may be appealed to the courts.

Rather than litigate a case fully, defendants may agree to consent decrees, in which, without admitting guilt, they agree not to carry on the activity complained of. Violations of injunctions, cease and desist orders, and consent decrees subject companies to a fine of $10,000 a day for every day the violation continues. Companies frequently enter into consent decrees—and not just because they wish to avoid the expense and trouble of trial. Section 5 of the Clayton Act says that whenever an antitrust case brought by the federal government under either the Clayton Act or the Sherman Act goes to final judgment, the judgment can be used, in a private suit in which the same facts are at issue, as prima facie evidence that the violation was committed. This is a powerful provision, because it means that a private plaintiff need prove only that the violation in fact injured him. He need not prove that the defendant committed the acts that amount to antitrust violations. Since this provision makes it relatively easy for private plaintiffs to prevail in subsequent suits, defendants in government suits have a strong inducement to enter into consent decrees, because these are not considered judgments. Likewise, a guilty plea in a criminal case gives the plaintiff in a later private civil suit prima facie evidence of the defendant's liability. However, a plea of nolo contendere will avoid this result. Section 5 has been the spur for a considerable proportion of all private antitrust suits. For example, the government's price-fixing case against the electric equipment industry that sent certain executives of General Electric to jail in the 1950s led to more than 2,200 private suits.

Treble Damages

The crux of the private suit is its unique damage award: any successful plaintiff is entitled to collect *three times* the amount of damages actually suffered—treble damages, as they are known—and to be paid the cost of his attorneys. These fees can be huge: defendants have had to pay out millions of dollars for attorneys' fees alone in single cases. The theory of treble damages is that they will serve as an incentive to private parties to police industry for antitrust violations, thus saving the federal government the immense expense of maintaining an adequate staff for that job.

Class Actions

One of the most important developments in antitrust law during the 1970s was the rise of the class action. Under liberalized rules of federal procedure, a single plaintiff may sue on behalf of the entire class of people injured by an antitrust violation. This device makes it possible to bring numerous suits that would otherwise never have been contemplated. A single individual who has paid one dollar more than he would have been charged in a competitive market obviously will not file suit. But if there are ten million

consumers like him, then in a class action he may seek—on behalf of the entire class, of course—$30 million ($10 million trebled), plus attorneys' fees. Critics charge that the class action is a device that in the antitrust field benefits only the lawyers, who have a large incentive to find a few plaintiffs willing to have their names used in a suit run entirely by the lawyers. Nevertheless, it is true that the class action permits antitrust violations to be rooted out that could not otherwise be attacked privately. During the 1970s, suits against drug companies and the wallboard manufacturing industry were among the many large-scale antitrust class actions.

Key Takeaway

The preservation of competition is an important part of public policy in the United States. The various antitrust laws were crafted in response to clear abuses by companies that sought to claim easier profits by avoiding competition through the exercise of monopoly power, price-fixing, or territorial agreements. The Department of Justice and the Federal Trade Commission have substantial criminal and civil penalties to wield in their enforcement of the various antitrust laws.

Exercises

1. Why did industries become so much larger after the US Civil War, and how did this lead to abusive practices? What role did politics play in creating US laws fostering competition?
2. Go to the Department of Justice website and see how many antitrust enforcement actions have taken place since 2008.
3. Consider whether the US government should break up the biggest US banks. Why or why not? If the United States does so, and other nations have very large government banks, or have very large private banks, can US banks remain competitive?

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15.2: Horizontal Restraints of Trade

Learning Objectives

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

- Know why competitors are the likely actors in horizontal restraints of trade.
- Explain what it means when the Supreme Court declares a certain practice to be a per se violation of the antitrust laws.
- Describe at least three ways in which otherwise competing parties can fix prices.
- Recognize why dividing territories is a horizontal restraint of trade.

Classification of antitrust cases and principles is not self-evident because so many cases turn on complex factual circumstances. One convenient way to group the cases is to look to the relationship of those who have agreed or conspired. If the parties are competitors—whether competing manufacturers, wholesalers, retailers, or others—there could be a horizontal restraint of trade. If the parties are at different levels of the distribution chain—for example, manufacturer and retailer—their agreement is said to involve a vertical restraint of trade. These categories are not airtight: a retailer might get competing manufacturers to agree not to supply a competitor of the retailer. This is a vertical restraint with horizontal effects.

Price-Fixing

Price-fixing agreements are per se violations of Section 1 of the Sherman Act. The per se rule was announced explicitly in *United States v. Trenton Potteries*, 273 U.S. 392 (1927). In that case, twenty individuals and twenty-three corporations, makers and distributors of 82 percent of the vitreous pottery bathroom fixtures used in the United States, were found guilty of having agreed to establish and adhere to a price schedule. On appeal, they did not dispute that they had combined to fix prices. They did argue that the jury should have been permitted to decide whether what they had done was reasonable. The Supreme Court disagreed, holding that any fixing of prices is a clear violation of the Sherman Act.

Nonprice Restraints of Trade

Allocating Territories

Suppose four ice-cream manufacturers decided one day that their efforts to compete in all four corners of the city were costly and destructive. Why not simply strike a bargain: each will sell ice cream to retail shops in only one quadrant of the city. This is not a pricing arrangement; each is free to sell at whatever price it desires. But it is a restraint of trade, for in carving up the territory in which each may sell, they make it impossible for grocery stores to obtain a choice among all four manufacturers. The point becomes obvious when the same kind of agreement is put on a national scale: suppose Ford and Toyota agreed that Ford would not sell its cars in New York and Toyota would not sell Toyotas in California.

Most cases of territorial allocation are examples of vertical restraints in which manufacturers and distributors strike a bargain. But some cases deal with horizontal allocation of territories. In *United States v. Sealy*, the defendant company licensed manufacturers to use the Sealy trademark on beds and mattresses and restricted the territories in which the manufacturers could sell.*United States v. Sealy*, 388 U.S. 350 (1967). The evidence showed that the licensees, some thirty small bedding manufacturers, actually owned the licensor and were using the arrangement to allocate the territory. It was held to be unlawful per se.

Exclusionary Agreements

We said earlier that it might be permissible for manufacturers, through a trade association, to establish certain quality standards for the convenience of the public. As long as these standards are not exclusionary and do not reflect any control over price, they might not inhibit competition. The UL mark on electrical and other equipment—a mark to show that the product conforms to specifications of the private Underwriters Laboratory—is an example. But suppose that certain widget producers establish the Scientific Safety Council, a membership association whose staff ostensibly assigns quality labels, marked SSC, to those manufacturers who meet certain engineering and safety standards. In fact, however, the manufacturers are using the widespread public acceptance of the SSC mark to keep the market to themselves by refusing to let nonmembers join and by refusing to let

nonmembers use the SSC mark, even if their widgets conform to the announced standards. This subterfuge would be a violation of Section 1 of the Sherman Act.

Boycotts

Agreements by competitors to boycott (refuse to deal with) those who engage in undesirable practices are unlawful. In an early case, a retailers' trade association circulated a list of wholesale distributors who sold directly to the public. The intent was to warn member retailers not to buy from those wholesalers. Although each member was free to act however it wanted, the Court saw in this blacklist a plan to promote a boycott.*Eastern State Lumber Dealers' Association v. United States*, 234 U.S. 600 (1914).

This policy remains true even if the objective of the boycott is to prevent unethical or even illegal activities. Members of a garment manufacturers association agreed with a textile manufacturers association not to use any textiles that had been "pirated" from designs made by members of the textile association. The garment manufacturers also pledged, among other things, not to sell their goods to any retailer who did not refrain from using pirated designs. The argument that this was the only way to prevent unscrupulous design pirates from operating fell on deaf judicial ears; the Supreme Court held the policy unlawful under Section 5 of the Federal Trade Commission (FTC) Act, the case having been brought by the FTC. (*Fashion Originators' Guild of America v. Federal Trade Commission*, 312 U.S. 457 (1941).)

Key Takeaway

Competitors can engage in horizontal restraints of trade by various means of price-fixing. They can also engage in horizontal price restraints of trade by allocating territories or by joint boycotts (refusals to deal). These restraints need not be substantial in order to be actionable as a violation of US antitrust laws.

Exercises

1. Suppose that BMW of North America tells its dealers that the prestigious M100 cannot be sold for more than $230,000. Explain why this could be a violation of antitrust law.
2. Suppose that JPMorgan Chase, the Bank of England, and the Bank of China agree that they will not compete for investment services, and that JPMorgan Chase is given an exclusive right to North and South America, Bank of England is given access rights to Europe, and Bank of China is given exclusive rights to Asia, India, and Australia. Is there a violation of US antitrust law here? If not, why not? If so, what act does it violate, and how?
3. "It's a free country." Why are agreements by competitors to boycott (to refuse to deal with) certain others considered a problem that needs to be dealt with by law?

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15.3: Vertical Restraints of Trade

Learning Objectives

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

- Distinguish vertical restraints of trade from horizontal restraints of trade.
- Describe exclusive dealing, and explain why exclusive dealing is anticompetitive in any way.
- Explain how tying one product's sale to that of another could be anticompetitive.

We have been exploring the Sherman Act as it applies to horizontal restraints of trade, restraints that are created between competitors. We now turn to vertical restraints—those that result from agreements between different levels of the chain of distribution, such as manufacturer and wholesaler or wholesaler and retailer.

Resale Price Maintenance

Is it permissible for manufacturers to require distributors or retailers to sell products at a set price? Generally, the answer is no, but the strict per se rule against any kind of resale price maintenance has been somewhat relaxed.

But why would a manufacturer want to fix the price at which the retailer sells its goods? There are several possibilities. For instance, sustained, long-term sales of many branded appliances and other goods depend on reliable servicing by the retailer. Unless the retailer can get a fair price, it will not provide good service. Anything less than good service will ultimately hurt the brand name and lead to fewer sales. Another possible argument for resale price maintenance is that unless all retailers must abide by a certain price, some goods will not be stocked at all. For instance, the argument runs, bookstores will not stock slow-selling books if they cannot be guaranteed a good price on best sellers. Stores free to discount best sellers will not have the profit margin to stock other types of books. To guarantee sales of best sellers to bookstores carrying many lines of books, it is necessary to put a floor under the price of books. Still another argument is that brand-name goods are inviting targets for loss-leader sales; if one merchant drastically discounts Extremis Widgets, other merchants may not want to carry the line, and the manufacturer may experience unwanted fluctuations in sales.

None of these reasons has completely appeased the critics of price-fixing, including the most important critics—the US federal judges. As long ago as 1910, in *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, the Supreme Court declared vertical price-fixing (what has come to be called resale price maintenance) unlawful under the Sherman Act. Dr. Miles Medical Company required wholesalers that bought its proprietary medicines to sign an agreement in which they agreed not to sell below a certain price and not to sell to retailers who did not have a "retail agency contract" with Dr. Miles. The retail agency contract similarly contained a price floor. Dr. Miles argued that since it was free to make or not make the medicines, it should be free to dictate the prices at which purchasers could sell them. The Court said that Dr. Miles's arrangement with more than four hundred jobbers (wholesale distributors) and twenty-five thousand retailers was no different than if the wholesalers or retailers agreed among themselves to fix the price. Dr. Miles "having sold its product at prices satisfactory to itself, the public is entitled to whatever advantage may be derived from a competition in the subsequent traffic." (*Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1910).)

In *Dr. Miles*, the company's restrictions impermissibly limited the freedom of choice of other drug distributors and retailers. Society was therefore deprived of various benefits it would have received from unrestricted distribution of the drugs. But academics and some judges argue that most vertical price restraints do not limit competition among competitors, and manufacturers retain the power to restrict output, and the power to raise prices. Arguably, vertical price restraints help to ensure economic efficiencies and maximize consumer welfare. Some of the same arguments noted in this section—such as the need to ensure good service for retail items—continue to be made in support of a rule of reason.

The Supreme Court has not accepted these arguments with regard to minimum prices but has increased the plaintiff's burden of proof by requiring evidence of an agreement on specific price levels. Where a discounter is terminated by a manufacturer, it will probably not be told exactly why, and very few manufacturers would be leaving evidence in writing that insists on dealers agreeing to minimum prices.

Moreover, in *State Oil Company v. Khan*, the Supreme Court held that "vertical maximum price fixing, like the majority of commercial arrangements subject to the antitrust laws, should be evaluated under the rule of reason." (*State Oil Company v. Khan*, 522 U.S. 3 (1997).) Vertical maximum price-fixing is not legal per se but should be analyzed under a rule of reason "to identify the situations in which it amounts to anti-competitive conduct."

Exclusive Dealing and Tying

We move now to a nonprice vertical form of restraint. Suppose you went to the grocery store intent on purchasing a bag of potato chips to satisfy a late-night craving. Imagine your surprise—and indignation—if the store manager waved a paper in your face and said, "I'll sell you this bag only on the condition that you sign this agreement to buy all of your potato chips in the next five years from me." Or if he said, "I'll sell only if you promise never to buy potato chips from my rival across the street." This is an **exclusive dealing agreement**, and if the effect may be to lessen competition substantially, it is unlawful under Section 3 of the Clayton Act. It also may be unlawful under Section 1 of the Sherman Act and Section 5 of the Federal Trade Commission (FTC) Act. Another form of exclusive dealing, known as a tying contract, is also prohibited under Section 3 of the Clayton Act and under the other statutes. A tying contract results when you are forced to take a certain product in order to get the product you are really after: "I'll sell you the potato chips you crave, but only if you purchase five pounds of my Grade B liver."

Section 3 of the Clayton Act declares it unlawful for any person engaged in commerce to lease or make a sale or contract for sale of goods, wares, merchandise, machinery, supplies or other commodities, whether patented or unpatented, for use, consumption or resale…or fix a price charged therefore, or discount from or rebate upon, such price, **on the condition…that the lessee or purchaser…shall not use or deal in the goods, wares, merchandise, machinery, supplies, or other commodities of a competitor or competitors of the lessor or seller**, where the effect of such lease, sale, or contract for sale or such condition…may be to substantially lessen competition or tend to erect a monopoly in any line of commerce. (emphasis added)

Anyone with certain market power over a commodity or other valuable item (such as a trademark) runs a serious risk of violating the Clayton Act or Sherman Act or both if he insists that the buyer must also take some other product as part of the bargain. Microsoft learned about the perils of "tying" in a case brought by the United States, nineteen individual states, and the District of Columbia. The allegation was that Microsoft had tied together various software programs on its operating system, Microsoft Windows. Windows came prepackaged with Microsoft's Internet Explorer (IE), its Windows Media Player, Outlook Express, and Microsoft Office. The United States claimed that Microsoft had bundled (or "tied") IE to sales of Windows 98, making IE difficult to remove from Windows 98 by not putting it on the Remove Programs list.

The government alleged that Microsoft had designed Windows 98 to work "unpleasantly" with Netscape Navigator and that this constituted an illegal tying of Windows 98 and IE. Microsoft argued that its web browser and mail reader were just parts of the operating system, included with other personal computer operating systems, and that the integration of the products was technologically justified. The United States Court of Appeals for the District of Columbia Circuit rejected Microsoft's claim that IE was simply one facet of its operating system, but the court held that the tie between Windows and IE should be analyzed deferentially under the rule of reason. The case settled before reaching final judicial resolution. (See *United States v. Microsoft*.*United States v. Microsoft*, 253 F.3d 34 (D.C. Cir. 2001).)

Nonprice Vertical Restraints: Allocating Territory and Customers

With horizontal restraints of trade, we have already seen that it is a per se violation of Section 1 of the Sherman Act for competitors to allocate customers and territory. But a vertical allocation of customers or territory is only illegal if competition to the markets as a whole is adversely affected. The key here is distinguishing intrabrand competition from interbrand competition. Suppose that Samsung electronics has relationships with ten different retailers in Gotham City. If Samsung decides to limit its contractual relationships to only six retailers, the market for consumer electronics in Gotham City is still competitive in terms of interbrand competition. Intrabrand competition, however, is now limited. It could be that consumers will pay slightly higher prices for Samsung electronics with only six different retailers selling those products in Gotham City. That is, intrabrand competition is lowered, but interbrand competition remains strong.

Notice that it is unlikely that the six remaining retailers will raise their prices substantially, since there is still strong interbrand competition. If the retailer only deals in Samsung electronics, it is unlikely to raise prices that much, given the strength of interbrand competition.

If the retailer carries Samsung and other brands, it will also not want to raise prices too much, for then its inventory of Samsung electronics will pile up, while its inventory of other electronics products will move off the shelves.

Why would Samsung want to limit its retail outlets in Gotham City at all? It may be that Samsung has decided that by firming up its dealer network, it can enhance service, offer a wider range of products at each of the remaining retailers, ensure improved technical and service support, increase a sense of commitment among the remaining retail outlets, or other good business reasons. Where the retailer deals in other electronic consumer brands as well, making sure that well-trained sales and service support is available for Samsung products can promote interbrand competition in Gotham City. Thus vertical allocation of retailers within the territory is not a per se violation of the Sherman Act. It is instead a rule of reason violation, or the law will intervene only if Samsung's activities have an anticompetitive effect on the market as a whole. Notice here that the only likely objections to the new allocation would come from those dealers who were contractually terminated and who are then effectively restricted from selling Samsung electronics.

There are other potentially legitimate territorial restrictions, and limits on what kind of customer the retailer can sell to will prevent a dealer or distributor from selling outside a certain territory or to a certain class of customers. Samsung may reduce its outlets in Iowa from four to two, and it may also impose limits on those retail outlets from marketing beyond certain areas in and near Iowa.

Suppose that a Monsanto representative selling various kinds of fertilizers and pesticides was permitted to sell only to individual farmers and not to co-ops or retail distributors, or was limited to the state of Iowa. The Supreme Court has held that such vertical territorial or customer searches are not per se violations of Section 1 of the Sherman Act, as the situations often increase "interbrand competition." Thus the rule of reason will apply to vertical allocation of customers and territory.

Nonprice Vertical Restraints: Exclusive Dealing Agreements

Often, a distributor or retailer agrees with the manufacturer or supplier not to carry the products of any other supplier. This is not in itself (per se) illegal under Section 1 of the Sherman Act or Section 3 of the Clayton Act. Only if these **exclusive dealing contracts** have an anticompetitive effect will there be an antitrust violation. Ideally, in a competitive market, there are no significant barriers to entry. In the real world, however, various deals are made that can and do restrict entry. Suppose that on his farm in Greeley, Colorado, Richard Tucker keeps goats, and he creates a fine, handcrafted goat cheese for the markets in Denver, Fort Collins, and Boulder, Colorado, and Cheyenne, Wyoming. In these markets, if Safeway, Whole Foods, Albertsons, and King Soopers already have suppliers, and the suppliers have gained exclusive dealing agreements, Tucker will be effectively barred from the market.

Suppose that Billy Goat Cheese is a nationally distributed brand of goat cheese and has created exclusive dealing arrangements with the four food chains in the four cities. Tucker could sue Billy Goat for violating antitrust laws if he finds out about the arrangements. But the courts will not assume a per se violation has taken place. Instead, the courts will look at the number of other distributors available, the portion of the market foreclosed by the exclusive dealing arrangements, the ease with which new distributors could enter the market, the possibility that Tucker could distribute the product himself, and legitimate business reasons that led the distributors to accept exclusive dealing contracts from Billy Goat Cheese.

Key Takeaway

Vertical restraints of trade can be related to price, can be in the form of tying arrangements, and can be in the form of allocating customers and territories. Vertical restraints can also come in the form of exclusive dealing agreements.

Exercises

1. Explain how a seller with a monopoly in one product and tying the sale of that product to a new product that has no such monopoly is in any way hurting competition. How "free" is the buyer to choose a product different from the seller's?
2. If your company wants to maintain its image as a high-end product provider, is it legal to create a floor for your product's prices? If so, under what circumstances?

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15.4: Exemptions

Learning Objectives

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

- Know and describe the various exemptions from US antitrust law.

Regulated Industries

Congress has subjected several industries to oversight by specific regulatory agencies. These include banking, securities and commodities exchanges, communications, transportation, and fuel and energy. The question often arises whether companies within those industries are immune to antitrust attack. No simple answer can be given. As a general rule, activities that fall directly within the authority of the regulatory agency are immune. The agency is said to have exclusive jurisdiction over the conduct—for example, the rate structure of the national stock exchanges, which are supervised by the Securities and Exchange Commission. But determining whether a particular case falls within a specific power of an agency is still up to the courts, and judges tend to read the antitrust laws broadly and the regulatory laws narrowly when they seem to clash. A doctrine known as primary jurisdiction often dictates that the question of regulatory propriety must first be submitted to the agency before the courts will rule on an antitrust question. If the agency decides the activity complained of is otherwise impermissible, the antitrust question becomes moot.

Organized Labor

In the Clayton Act, Congress explicitly exempted labor unions from the antitrust laws in order to permit workers to band together. Section 6 says that "the labor of a human being is not a commodity or article of commerce. Nothing contained in the antitrust laws shall be construed to forbid the existence and operation of labor…organizations,…nor shall such organizations, or the members thereof, be held or construed to be illegal combinations or conspiracies in restraint of trade, under the antitrust laws." This provision was included to reverse earlier decisions of the courts that had applied the Sherman Act more against labor than business. Nevertheless, the immunity is not total, and unions have run afoul of the laws when they have combined with nonlabor groups to achieve a purpose unlawful under the antitrust laws. Thus a union could not bargain with an employer to sell its products above a certain price floor.

Insurance Companies

Under the McCarran-Ferguson Act of 1945, insurance companies are not covered by the antitrust laws to the extent that the states regulate the business of insurance. Whether or not the states adequately regulate insurance and the degree to which the exemption applies are complex questions, and there has been some political pressure to repeal the insurance exemption.

State Action

In 1943, the Supreme Court ruled in *Parker v. Brown* that when a valid state law regulates a particular industry practice and the industry members are bound to follow that law, then they are exempt from the federal antitrust laws. (*Parker v. Brown*, 317 U.S. 341 (1943).) Such laws include regulation of public power and licensing and regulation of the professions. This exemption for "state action" has proved troublesome and, like the other exemptions, a complex matter to apply. But it is clear that the state law must require or compel the action and not merely permit it. No state law would be valid if it simply said, "Bakers in the state may jointly establish tariffs for the sale of cookies."

The recent trend of Supreme Court decisions is to construe the exemption as narrowly as possible. A city, county, or other subordinate unit of a state is not immune under the *Parker* doctrine. A municipality can escape the consequences of antitrust violations—for example, in its operation of utilities—only if it is carrying out express policy of the state. Even then, a state-mandated price-fixing scheme may not survive a federal antitrust attack. New York law required liquor retailers to charge a certain minimum price, but because the state itself did not actively supervise the policy it had established, it fell to the Supreme Court's antitrust axe.

Baseball

Baseball, the Supreme Court said back in 1923, is not “in commerce.” Congress has never seen fit to overturn this doctrine. Although some inroads have been made in the way that the leagues and clubs may exercise their power, the basic decision stands. Some things are sacred.

Key Takeaway

For various reasons over time, certain industries and organized groups have been exempted from the operation of US antitrust laws. These include organized labor, insurance companies, and baseball. In addition, First Amendment concerns allow trade groups to solicit both state and federal governments, and state law may sometimes provide a “state action” exemption.

Exercises

1. Do a little Internet research. Find out why Curt Flood brought an antitrust lawsuit against Major League Baseball and what the Supreme Court did with his case.

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15.5: Sherman Act, Section 2- Concentrations of Market Power

Learning Objectives

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

- Understand the ways in which monopoly power can be injurious to competition.
- Explain why not all monopolies are illegal under the Sherman Act.
- Recognize the importance of defining the relevant market in terms of both geography and product.
- Describe the remedies for Sherman Act Section 2 violations.

Introduction

Large companies, or any company that occupies a large portion of any market segment, can thwart competition through the exercise of **monopoly power**. Indeed, monopoly means the lack of competition, or at least of effective competition. As the Supreme Court has long defined it, **monopoly** is "the power to control market prices or exclude competition." (*United States v. Grinnell Corp.*, 384 U.S. 563, 571 (1966).) Public concern about the economic and political power of the large trusts, which tended to become monopolies in the late nineteenth century, led to Section 2 of the Sherman Act in 1890 and to Section 7 of the Clayton Act in 1914. These statutes are not limited to the giants of American industry, such as ExxonMobil, Microsoft, Google, or AT&T. A far smaller company that dominates a relatively small geographic area or that merges with another company in an area where few others compete can be in for trouble under Sections 2 or 7. These laws should therefore be of concern to all businesses, not just those on the *Fortune* 500 list. In this section, we will consider how the courts have interpreted both the Section 2 prohibition against monopolizing and the Section 7 prohibition against mergers and acquisitions that tend to lessen competition or to create monopolies.

Section 2 of the Sherman Act reads as follows: "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several states, or with foreign nations, shall be deemed guilty of a [felony]."

We begin the analysis of Section 2 with the basic proposition that a monopoly is not per se unlawful. Section 2 itself makes this proposition inescapable: it forbids the act of *monopolizing*, not the condition or attribute of *monopoly*. Why should that be so? If monopoly power is detrimental to a functioning competitive market system, why shouldn't the law ban the very existence of a monopoly?

The answer is that we cannot hope to have "perfect competition" but only "workable competition." Any number of circumstances might lead to monopolies that we would not want to eliminate. Demand for a product might be limited to what one company could produce, there thus being no incentive for any competitor to come into the market. A small town may be able to support only one supermarket, newspaper, or computer outlet. If a company is operating efficiently through economies of scale, we would not want to split it apart and watch the resulting companies fail. An innovator may have a field all to himself, yet we would not want to penalize the inventor for his very act of invention. Or a company might simply be smarter and more efficient, finally coming to stand alone through the very operation of competitive pressures. It would be an irony indeed if the law were to condemn a company that was forged in the fires of competition itself. As the Supreme Court has said, the Sherman Act was designed to protect competition, not competitors.

A company that has had a monopoly position "thrust upon it" is perfectly lawful. The law penalizes not the monopolist as such but the competitor who gains his monopoly power through illegitimate means with an intent to become a monopolist, or who after having become a monopolist acts illegitimately to maintain his power.

A Section 2 case involves three essential factors:

1. What is the relevant market for determining dominance? The question of relevant market has two aspects: a geographic market dimension and a relevant product market dimension. It makes a considerable difference whether the company is thought to be a competitor in ten states or only one. A large company in one state may appear tiny matched against competitors operating in many states. Likewise, if the product itself has real substitutes, it makes little sense to brand its maker a monopolist. For

instance, Coca-Cola is made by only one company, but that does not make the Coca-Cola Company a monopoly, for its soft drink competes with many in the marketplace.

2. How much monopoly power is too much? What share of the market must a company have to be labeled a monopoly? Is a company with 50 percent of the market a monopoly? 75 percent? 90 percent?
3. What constitutes an illegitimate means of gaining or maintaining monopoly power?

These factors are often closely intertwined, especially the first two. This makes it difficult to examine each separately, but to the extent possible, we will address each factor in the order given.

Relevant Markets: Product Market and Geographic Market

Product Market

The monopolist never exercises power in the abstract. When exercised, monopoly power is used to set prices or exclude competition in the market for a particular product or products. Therefore it is essential in any Section 2 case to determine what products to include in the relevant market.

The Supreme Court looks at "cross-elasticity of demand" to determine the relevant market. That is, to what degree can a substitute be found for the product in question if the producer sets the price too high? If consumers stay with the product as its price rises, moving to a substitute only at a very high price, then the product is probably in a market by itself. If consumers shift to another product with slight rises in price, then the product market is "elastic" and must include all such substitutes.

Geographic Market

A company doesn't have to dominate the world market for a particular product or service in order to be held to be a monopolist. The Sherman Act speaks of "any part" of the trade or commerce. The Supreme Court defines this as the "area of effective competition." Ordinarily, the smaller the part the government can point to, the greater its chances of prevailing, since a company usually will have greater control over a single marketplace than a regional or national market. Because of this, alleged monopolists will usually argue for a broad geographic market, while the government tries to narrow it by pointing to such factors as transportation costs and the degree to which consumers will shop outside the defined area.

Monopoly Power

After the relevant product and geographic markets are defined, the next question is whether the defendant has sufficient power within them to constitute a monopoly. The usual test is the market share the alleged monopolist enjoys, although no rigid rule or mathematical formula is possible. In *United States v. Aluminum Company of America*, presented in Section 26.8.3 "Acquiring and Maintaining a Monopoly" of this chapter, Judge Learned Hand said that Alcoa's 90 percent share of the ingot market was enough to constitute a monopoly but that 64 percent would have been doubtful.*United States v. Aluminum Co. of America*, 148 F.2d 416 (2d Cir. 1945). In a case against DuPont many years ago, the court looked at a 75 percent market share in cellophane but found that the relevant market (considering the cross-elasticity of demand) was not restricted to cellophane.

Monopolization: Acquiring and Maintaining a Monopoly

Possessing a monopoly is not per se unlawful. Once a company has been found to have monopoly power in a relevant market, the final question is whether it either acquired its monopoly power in an unlawful way or has acted unlawfully to maintain it. This additional element of "deliberateness" does not mean that the government must prove that the defendant *intended* monopolization, in the sense that what it *desired* was the complete exclusion of all competitors. It is enough to show that the monopoly would probably result from its actions, for as Judge Hand put it, "No monopolist monopolizes unconscious of what he is doing."

What constitutes proof of unlawful acquisition or maintenance of a monopoly? In general, proof is made by showing that the defendant's acts were aimed at or had the probable effect of excluding competitors from the market. Violations of Section 1 or other provisions of the antitrust laws are examples. "Predatory pricing"—charging less than cost—can be evidence that the defendant's purpose was monopolistic, for small companies cannot compete with large manufacturers capable of sustaining continued losses until the competition folds up and ceases operations.

In *United States v. Lorain Journal Company*, the town of Lorain, Ohio, could support only one newspaper.*United States v. Lorain Journal Company*, 342 U.S. 143 (1951). With a circulation of twenty thousand, the *Lorain Journal* reached more than 99 percent of

the town's families. The *Journal* had thus lawfully become a monopoly. But when a radio station was set up, the paper found itself competing directly for local and national advertising. To retaliate, the *Journal* refused to accept advertisements unless the advertiser agreed not to advertise on the local station. The Court agreed that this was an unlawful attempt to boycott and hence was a violation of Section 2 because the paper was using its monopoly power to exclude a competitor. (Where was the *interstate* commerce that would bring the activity under federal law? The Court said that the radio station was in interstate commerce because it broadcast national news supported by national advertising.)

Practices that help a company acquire or maintain its monopoly position need not be unlawful in themselves. In the *Aluminum Company* case, Alcoa claimed its monopoly power was the result of superior business skills and techniques. These superior skills led it to constantly build plant capacity and expand output at every opportunity. But Judge Hand thought otherwise, given that for a quarter of a century other producers could not break into the market because Alcoa acted at every turn to make it impossible for them to compete, even as Alcoa increased its output by some 800 percent. Judge Hand's explanation remains the classic exposition.

Innovation as Evidence of Intent to Monopolize

During the 1970s, several monopolization cases seeking huge damages were filed against a number of well-known companies, including Xerox, International Business Machines (IBM), and Eastman Kodak. In particular, IBM was hit with several suits as an outgrowth of the Justice Department's lawsuit against the computer maker. (*United States v. IBM* was filed in 1969 and did not terminate until 1982, when the government agreed to drop all charges, a complete victory for the company.) The plaintiffs in many of these suits—SCM Corporation against Xerox, California Computer Products Incorporated against IBM (the *Calcomp* case), Berkey Photo Incorporated against Kodak—charged that the defendants had maintained their alleged monopolies by strategically introducing key product innovations that rendered competitive products obsolete. For example, hundreds of computer companies manufacture peripheral equipment "plug-compatible" with IBM computers. Likewise, Berkey manufactured film usable in Kodak cameras. When the underlying products are changed—mainframe computers, new types of cameras—the existing manufacturers are left with unusable inventory and face a considerable time lag in designing new peripheral equipment. In some of these cases, the plaintiffs managed to obtain sizable treble damage awards—SCM won more than $110 million, IBM initially lost one case in the amount of $260 million, and Berkey bested Kodak to the tune of $87 million. Had these cases been sustained on appeal, a radical new doctrine would have been imported into the antitrust laws—that innovation for the sake of competing is unlawful.

None of these cases withstood appellate scrutiny. The Supreme Court has not heard cases in this area, so the law that has emerged is from decisions of the federal courts of appeals. A typical case is *ILC Peripherals Leasing Corp. v. International Business Machines* (the *Memorex* case).*ILC Peripherals Leasing Corp. v. International Business Machines*, 458 F.Supp. 423 (N.D. Cal. 1978). Memorex argued that among other things, IBM's tactic of introducing a new generation of computer technology at lower prices constituted monopolization. The court disagreed, noting that other companies could "reverse engineer" IBM equipment much more cheaply than IBM could originally design it and that IBM computers and related products were subject to intense competition to the benefit of plug-compatible equipment users. The actions of IBM undoubtedly hurt Memorex, but they were part and parcel of the competitive system, the very essence of competition. "This kind of conduct by IBM," the court said, "is precisely what the antitrust laws were meant to encourage.…Memorex sought to use the antitrust laws to make time stand still and preserve its very profitable position. This court will not assist it and the others who would follow after in this endeavor."

The various strands of the innovation debate are perhaps best summed up in *Berkey Photo, Inc. v. Eastman Kodak Company*, Section 26.8.4 "Innovation and Intent to Monopolize".

Attempts to Monopolize

Section 2 prohibits not only actual monopolization but also attempts to monopolize. An attempt need not succeed to be unlawful; a defendant who tries to exercise sway over a relevant market can take no legal comfort from failure. In any event, the plaintiff must show a specific intent to monopolize, not merely an intent to commit the act or acts that constitute the attempt.

Remedies

Since many of the defendant's acts that constitute Sherman Act Section 2 monopolizing are also violations of Section 1 of the Clayton Act, why should plaintiffs resort to Section 2 at all? What practical difference does Section 2 make? One answer is that not every act of monopolizing is a violation of another law. Leasing and pricing practices that are perfectly lawful for an ordinary

competitor may be unlawful only because of Section 2. But the more important reason is the remedy provided by the Sherman Act: divestiture. In the right case, the courts may order the company broken up.

In the *Standard Oil* decision of 1911, the Supreme Court held that the Standard Oil Company constituted a monopoly and ordered it split apart into separate companies. Several other trusts were similarly dealt with. In many of the early cases, doing so posed no insuperable difficulties, because the companies themselves essentially consisted of separate manufacturing plants knit together by financial controls. But not every company is a loose confederation of potentially separate operating companies.

The *Alcoa* case (Section 26.8.3 "Acquiring and Maintaining a Monopoly") was fraught with difficult remedial issues. Judge Hand's opinion came down in 1945, but the remedial side of the case did not come up until 1950. By then the industry had changed radically, with the entrance of Reynolds and Kaiser as effective competitors, reducing Alcoa's share of the market to 50 percent. Because any aluminum producer needs considerable resources to succeed and because aluminum production is crucial to national security, the later court refused to order the company broken apart. The court ordered Alcoa to take a series of measures that would boost competition in the industry. For example, Alcoa stockholders had to divest themselves of the stock of a closely related Canadian producer in order to remove Alcoa's control of that company; and the court rendered unenforceable a patent-licensing agreement with Reynolds and Kaiser that required them to share their inventions with Alcoa, even though neither the Canadian tie nor the patent agreements were in themselves unlawful.

Although the trend has been away from breaking up the monopolist, it is still employed as a potent remedy. In perhaps the largest monopolization case ever brought—*United States v. American Telephone & Telegraph Company*—the government sought divestiture of several of AT&T's constituent companies, including Western Electric and the various local operating companies. To avoid prolonged litigation, AT&T agreed in 1982 to a consent decree that required it to spin off all its operating companies, companies that had been central to AT&T's decades-long monopoly.

Key Takeaway

Aggressive competition is good for consumers and for the market, but if the company has enough power to control a market, the benefits to society decrease. Under Section 2 of the Sherman Act, it is illegal to monopolize or attempt to monopolize the market. If the company acquires a monopoly in the wrong way, using wrongful tactics, it is illegal under Section 2. Courts will look at three questions to see if a company has illegally monopolized a market: (1) What is the relevant market? (2) Does the company control the market? and (3) How did the company acquire or maintain its control?

Exercises

1. Mammoth Company, through three subsidiaries, controls 87 percent of the equipment to operate central station hazard-detecting devices; these devices are used to prevent burglary and detect fires and to provide electronic notification to police and fire departments at a central location. In an antitrust lawsuit, Mammoth Company claims that there are other means of protecting against burglary and it therefore does not have monopoly power. Explain how the Justice Department may be able to prove its claim that Mammoth Company is operating an illegal monopoly.
2. Name the sanctions used to enforce Section 2 of the Sherman Act.
3. Look at any news database or the Department of Justice antitrust website for the past three years and describe a case involving a challenge to the exercise of a US company's monopoly power.

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15.6: Summary and Exercises

Summary

Four basic antitrust laws regulate the competitive activities of US business: the Sherman Act, the Clayton Act, the Federal Trade Commission Act, and the Robinson-Patman Act. The Sherman Act prohibits restraints of trade and monopolizing. The Clayton Act prohibits a variety of anticompetitive acts, including mergers and acquisitions that might tend to lessen competition. The Federal Trade Commission Act prohibits unfair methods of competition and unfair and deceptive acts or practices in commerce. The Robinson-Patman Act prohibits a variety of price discriminations. (This act is actually an amendment to the Clayton Act.) These laws are enforced in four ways: (1) by the US Department of Justice, Antitrust Division; (2) by the Federal Trade Commission; (3) by state attorneys general; and (4) by private litigants.

The courts have interpreted Section 1 of the Sherman Act, prohibiting every contract, combination, or conspiracy in restraint of trade, by using a rule of reason. Thus reasonable restraints that are ancillary to legitimate business practices are lawful. But some acts are per se unreasonable, such as price-fixing, and will violate Section 1. Section 1 restraints of trade include both horizontal and vertical restraints of trade. Vertical restraints of trade include resale price maintenance, refusals to deal, and unreasonable territorial restrictions on distributors. Horizontal restraints of trade include price-fixing, exchanging price information when doing so permits industry members to control prices, controlling output, regulating competitive methods, allocating territories, exclusionary agreements, and boycotts.

Exclusive dealing contracts and tying contracts whose effects may be to substantially lessen competition violate Section 3 of the Clayton Act and may also violate both Section 1 of the Sherman Act and Section 5 of the Federal Trade Commission Act. Requirements and supply contracts are unlawful if they tie up so much of a commodity that they tend substantially to lessen competition or might tend to do so.

The Robinson-Patman Act (Section 2 of the Clayton Act) prohibits price discrimination for different purchasers of commodities of like grade and quality if the effect may be substantially to (1) lessen competition or tend to create a monopoly in any line of commerce or (2) impair competition with (a) any person who grants or (b) knowingly receives the benefit of the discrimination, or (c) with customers of either of them.

Some industries and groups are insulated from the direct reach of the antitrust laws. These include industries separately regulated under federal law, organized labor, insurance companies, activities mandated under state law, group solicitation government action, and baseball.

Section 2 of the Sherman Act prohibits monopolizing or attempting to monopolize any part of interstate or foreign trade or commerce. The law does not forbid monopoly as such but only acts or attempts or conspiracies to monopolize. The prohibition includes the monopolist who has acquired his monopoly through illegitimate means.

Three factors are essential in a Section 2 case: (1) relevant market for determining dominance, (2) the degree of monopoly power, and (3) the particular acts claimed to be illegitimate.

Exercises

1. To protect its state's businesses against ruinous price wars, a state legislature has passed a law permitting manufacturers to set a "suggested resale price" on all goods that they make and sell direct to retailers. Retailers are forbidden to undercut the resale price by more than 10 percent. A retailer who violates the law may be sued by the manufacturer for treble damages: three times the difference between the suggested resale price and the actual selling price. But out-of-state retailers are bound by no such law and are regularly discounting the goods between 35 and 40 percent. As the general manager of a large discount store located within a few miles of a city across the state line, you wish to offer the public a price of only 60 percent of the suggested retail price on items covered by the law in order to compete with the out-of-state retailers to which your customers have easy access. May you lower your price in order to compete? How would you defend yourself if sued by a manufacturer whose goods you discounted in violation of the law?
2. The DiForio Motor Car Company is a small manufacturer of automobiles and sells to three distributors in the city of Peoria. The largest distributor, Hugh's Auras, tells DiForio that it is losing money on its dealership and will quit selling the cars unless DiForio agrees to give it an exclusive contract. DiForio tells the other distributors, whose contracts were renewed from year to

year, that it will no longer sell them cars at the end of the contract year. Smith Autos, one of the other dealers, protests, but DiForio refuses to resupply it. Smith Autos sues DiForio and Hugh's. What is the result? Why?

3. Twenty-five local supermarket chains banded together as Topco Associates Incorporated to sell groceries under a private label. Topco was formed in 1940 to compete with the giant chains, which had the economic clout to sell private-label merchandise unavailable to the smaller chains. Topco acted as a purchasing agent for the members. By the late 1960s, Topco's members were doing a booming business: $1.3 billion in retail sales, with market share ranging from 1.5 percent to 16 percent in the markets that members served. Topco-brand groceries accounted for no more than 10 percent of any store's total merchandise. Under Topco's rules, members were assigned exclusive territories in which to sell Topco-brand goods. A member chain with stores located in another member's exclusive territory could not sell Topco-brand goods in those stores. Topco argued that the market division was necessary to give each chain the economic incentive to advertise and develop brand consciousness and thus to be able to compete more effectively against the large nonmember supermarkets' private labels. If other stores in the locality could also carry the Topco brand, then it would not be a truly "private" label and there would be no reason to tout it; it would be like any national brand foodstuff, and Topco members did not have the funds to advertise the brand nationally. Which, if any, antitrust laws has Topco violated? Why?
4. In 1983, Panda Bears Incorporated, a small manufacturer, began to sell its patented panda bear robot dolls (they walk, smile, and eat bamboo shoots) to retail toy shops. The public took an immediate fancy to panda bears, and the company found it difficult to meet the demand. Retail shops sold out even before their orders arrived. In order to allocate the limited supply fairly while it tooled up to increase production runs, the company announced to its distributors that it would not sell to any retailers that did not also purchase its trademarked Panda Bear's Bambino Bamboo Shoots. It also announced that it would refuse to supply any retailer that sold the robots for less than $59.95. Finally, it said that it would refuse to sell to retailers unless they agreed to use the company's repair services exclusively when customers brought bears back to repair malfunctions in their delicate, patented computerized nervous system. By the following year, with demand still rising, inferior competitive panda robots and bamboo shoots began to appear. Some retailers began to lower the Panda Bear price to meet the competition. The company refused to resupply them. Panda Bears Incorporated also decreed that it would refuse to sell to retailers who carried any other type of bamboo shoot. What antitrust violations, if any, has Panda Bear Incorporated committed? What additional information might be useful in helping you to decide?
5. Elmer has invented a new battery-operated car. The battery, which Elmer has patented, functions for five hundred miles before needing to be recharged. The car, which he has named The Elmer, is a sensation when announced, and his factory can barely keep up with the orders. Worried about the impact, all the other car manufacturers ask Elmer for a license to use the battery in their cars. Elmer refuses because he wants the car market all to himself. Banks are eager to lend him the money to expand his production, and within three years he has gained a 5 percent share of the national market for automobiles. During these years, Elmer has kept the price of The Elmer high, to pay for his large costs in tooling up a factory. But then it dawns on him that he can expand his market much more rapidly if he drops his price, so he prices the car to yield the smallest profit margin of any car being sold in the country. Its retail price is far lower than that of any other domestic car on the market. Business begins to boom. Within three more years, he has garnered an additional 30 percent of the market, and he announces at a press conference that he confidently expects to have the market "all to myself" within the next five years. Fighting for their lives now, the Big Three auto manufacturers consult their lawyers about suing Elmer for monopolizing. Do they have a case? What is Elmer's defense?
6. National Widget Company is the dominant manufacturer of widgets in the United States, with 72 percent of the market for low-priced widgets and 89 percent of the market for high-priced widgets. Dozens of companies compete with National in the manufacture and sale of compatible peripheral equipment for use with National's widgets, including countertops, holders, sprockets and gear assemblies, instruction booklets, computer software, and several hundred replacements parts. Revenues of these peripherals run upwards of $100 million annually. Beginning with the 1981 model year, National Widget sprang a surprise: a completely redesigned widget that made most of the peripheral equipment obsolete. Moreover, National set the price for its peripherals below that which would make economic sense for competitors to invest in new plants to tool up for producing redesigned peripherals. Five of the largest peripheral-equipment competitors sued National under Section 2 of the Sherman Act. One of these, American Widget Peripherals, Inc., had an additional complaint: on making inquiries in early 1980, American was assured by National's general manager that it would not be redesigning any widgets until late 1985 at the earliest. On the basis of that statement, American invested $50 million in a new plant to manufacture the now obsolescent peripheral equipment, and as a result, it will probably be forced into bankruptcy. What is the result? Why? How does this differ, if at all, from the *Berkey Camera* case?

7. In 1959, The Aluminum Company of America (Alcoa) acquired the stock and assets of the Rome Cable Corporation. Alcoa and Rome both manufactured bare and insulated aluminum wire and cable, used for overhead electric power transmission lines. Rome, but not Alcoa, manufactured copper conductor, used for underground transmissions. Insulated aluminum wire and cable is quite inferior to copper, but it can be used effectively for overhead transmission, and Alcoa increased its share of annual installations from 6.5 percent in 1950 to 77.2 percent in 1959. During that time, copper lost out to aluminum for overhead transmission. Aluminum and copper conductor prices do not respond to one another; lower copper conductor prices do not put great pressure on aluminum wire and cable prices. As the Supreme Court summarized the facts in *United States v. Aluminum Co. of America*,*United States v. Aluminum Co. of America*, 377 U.S. 271 (1964).In 1958—the year prior to the merger—Alcoa was the leading producer of aluminum conductor, with 27.8% of the market; in bare aluminum conductor, it also led the industry with 32.5%. Alcoa plus Kaiser controlled 50% of the aluminum conductor market and, with its three leading competitors, more than 76%. Only nine concerns (including Rome with 1.3%) accounted for 95.7% of the output of aluminum conductor, Alcoa was third with 11.6%, and Rome was eighth with 4.7%. Five companies controlled 65.4% and four smaller ones, including Rome, added another 22.8%. The Justice Department sued Alcoa-Rome for violation of Section 7 of the Clayton Act. What is the government's argument? What is the result?
8. Quality Graphics has been buying up the stock of companies that manufacture billboards. Quality now owns or controls 23 of the 129 companies that make billboards, and its sales account for 3.2 percent of the total national market of $72 million. In Texas, Quality has acquired 27 percent of the billboard market, and in the Dallas–Ft. Worth area alone, about 25 percent. Billboard advertising accounts for only 0.001 percent of total national advertising sales; the majority goes to newspaper, magazine, television, and radio advertising. What claims could the Justice Department assert in a suit against Quality? What is Quality's defense? What is the result?
9. The widget industry consists of six large manufacturers who together account for 62 percent of output, which in 1985 amounted to $2.1 billion in domestic US sales. The remaining 38 percent is supplied by more than forty manufacturers. All six of the large manufacturers and thirty-one of the forty small manufacturers belong to the Widget Manufacturers Trade Association (WMTA). An officer from at least two of the six manufacturers always serves on the WMTA executive committee, which consists of seven members. The full WMTA board of directors consists of one member from each manufacturer. The executive committee meets once a month for dinner at the Widgeters Club; the full board meets semiannually at the Widget Show. The executive committee, which always meets with the association's lawyer in attendance, discusses a wide range of matters, including industry conditions, economic trends, customer relations, technological developments, and the like, but scrupulously refrains from discussing price, territories, or output. However, after dinner at the bar, five of the seven members meet for drinks and discuss prices in an informal manner. The chairman of the executive committee concludes the discussion with the following statement: "If I had to guess, I'd guess that the unit price will increase by 5 percent the first of next month." On the first of the month, his prediction is proven to be correct among the five companies whose officers had a drink, and within a week, most of the other manufacturers likewise increase their prices. At the semiannual meeting of the full board, the WMTA chairman notes that prices have been climbing steadily, and he ventures the hope that they will not continue to do so because otherwise they will face stiff competition from the widget industry. However, following the next several meetings of the executive committee, the price continues to rise as before. The Justice Department gets wind of these discussions and sues the companies whose officers are members of the board of directors and also sues individually the members of the executive committee and the chairman of the full board. What laws have they violated, if any, and who has violated them? What remedies or sanctions may the department seek?

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CHAPTER OVERVIEW

16: Personal Property and Fixtures

Learning Objectives

After reading this chapter, you should understand the following:

- The difference between personal property and other types of property
- How rights in personal property are acquired and maintained
- How some types of personal property can become real property, and how to determine who has rights in fixtures that are part of real property

In this chapter, we examine the general nature of property rights and the law relating to personal property—with special emphasis on acquisition and fixtures. We discuss intellectual property, a kind of personal property that is increasingly profitable. We focus on real property, including its nature and regulation, its acquisition by purchase (and some other methods), and its acquisition by lease (landlord and tenant law).

16.1: The General Nature of Property Rights
16.2: Personal Property
16.3: Fixtures
16.4: Summary and Exercises

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16.1: The General Nature of Property Rights

Learning Objectives

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

- Understand the elastic and evolving boundaries of what the law recognizes as property that can be bought or sold on the market.
- Distinguish real property from personal property.

Definition of Property

Property, which seems like a commonsense concept, is difficult to define in an intelligible way; philosophers have been striving to define it for the past 2,500 years. To say that "property is what we own" is to beg the question—that is, to substitute a synonym for the word we are trying to define. Blackstone's famous definition is somewhat wordy: "The right of property is that sole and despotic dominion which one man claims and exercises over the external things of the world, in total exclusion of the right of any other individual in the universe. It consists in the free use, enjoyment, and disposal of all a person's acquisitions, without any control or diminution save only by the laws of the land." A more concise definition, but perhaps too broad, comes from the Restatement of the Law of Property, which defines property as the "legal relationship between persons with respect to a thing."

The Restatement's definition makes an important point: property is a *legal relationship*, the power of one person to use objects in ways that affect others, to exclude others from the property, and to acquire and transfer property. Still, this definition does not contain a specific list of those nonhuman "objects" that could be in such a relationship. We all know that we can own personal objects like iPods and DVDs, and even more complex objects like homes and minerals under the ground. Property also embraces objects whose worth is representative or symbolic: ownership of stock in a corporation is valued not for the piece of paper called a stock certificate but for dividends, the power to vote for directors, and the right to sell the stock on the open market. Wholly intangible things or objects like copyrights and patents and bank accounts are capable of being owned as property. But the list of things that can be property is not fixed, for our concept of property continues to evolve. Collateralized debt obligations (CDOs) and structured investment vehicles (SIVs), prime players in the subprime mortgage crisis, were not on anyone's list of possible property thirty years ago. Bitcoin and Non-Fungible Tokens (NFTs) didn't exist ten years ago.

The Economist's View

Property is not just a legal concept, of course, and different disciplines express different philosophies about the purpose of property and the nature of property rights. To the jurist, property rights should be protected because it is just to do so. To an economist, the legal protection of property rights functions to create incentives to use resources efficiently. For a truly efficient system of property rights, some economists would require universality (everything is owned), exclusivity (the owners of each thing may exclude all others from using it), and transferability (owners may exchange their property). Together, these aspects of property would lead, under an appropriate economic model, to efficient production and distribution of goods. But the law of property does not entirely conform to the economic conception of the ownership of productive property by private parties; there remain many kinds of property that are not privately owned and some parts of the earth that are considered part of "the commons." For example, large areas of the earth's oceans are not "owned" by any one person or nation-state, and certain land areas (e.g., Yellowstone National Park) are not in private hands.

Classification of Property

Property can be classified in various ways, including tangible versus intangible, private versus public, and personal versus real. Tangible property is that which physically exists, like a building, a popsicle stand, a hair dryer, or a steamroller. Intangible property is something without physical reality that entitles the owner to certain benefits; stocks, bonds, and intellectual property would be common examples. Public property is that which is owned by any branch of government; private property is that which is owned by anyone else, including a corporation.

Perhaps the most important distinction is between real and personal property. Essentially, real property is immovable; personal property is movable. At common law, personal property has been referred to as "chattels." When chattels become affixed to real

property in a certain manner, they are called fixtures and are treated as real property. (For example, a bathroom cabinet purchased at Home Depot and screwed into the bathroom wall may be converted to part of the real property when it is affixed.) Fixtures are discussed in Section 29.3 of this chapter.

Importance of the Distinction between Real and Personal Property

In our legal system, the distinction between real and personal property is significant in several ways. For example, the sale of personal property, but not real property, is governed by Article 2 of the Uniform Commercial Code (UCC). Real estate transactions, by contrast, are governed by the general law of contracts. Suppose goods are exchanged for realty. Section 2-304 of the UCC says that the transfer of the goods and the seller's obligations with reference to them are subject to Article 2, but not the transfer of the interests in realty nor the transferor's obligations in connection with them.

The form of transfer depends on whether the property is real or personal. Real property is normally transferred by a deed, which must meet formal requirements dictated by state law. By contrast, transfer of personal property often can take place without any documents at all.

Another difference can be found in the law that governs the transfer of property on death. A person's heirs depend on the law of the state for distribution of his property if he dies intestate—that is, without a will. Who the heirs are and what their share of the property will be may depend on whether the property is real or personal. For example, widows may be entitled to a different percentage of real property than personal property when their husbands die intestate.

Tax laws also differ in their approach to real and personal property. In particular, the rules of valuation, depreciation, and enforcement depend on the character of the property. Thus real property depreciates more slowly than personal property, and real property owners generally have a longer time than personal property owners to make good unpaid taxes before the state seizes the property.

Key Takeaway

Property is difficult to define conclusively, and there are many different classifications of property. There can be public property as well as private property, tangible property as well as intangible property, and, most importantly, real property as well as personal property. These are important distinctions, with many legal consequences.

Exercises

1. Kristen buys a parcel of land on Marion Street, a new and publicly maintained roadway. Her town's ordinances say that each property owner on a public street must also provide a sidewalk within ten feet of the curb. A year after buying the parcel, Kristen commissions a house to be built on the land, and the contractor begins by building a sidewalk in accordance with the town's ordinance. Is the sidewalk public property or private property? If it snows, and if Kristen fails to remove the snow and it melts and ices over and a pedestrian slips and falls, who is responsible for the pedestrian's injuries?
2. When can private property become public property? Does public property ever become private property?

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16.2: Personal Property

Learning Objectives

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

- Explain the various ways that personal property can be acquired by means other than purchase.

Most legal issues about personal property center on its acquisition. Acquisition by purchase is the most common way we acquire personal property, but there are at least five other ways to legally acquire personal property: (1) possession, (2) finding lost or misplaced property, (3) gift, (4) accession, and (5) confusion.

Possession

It is often said that "possession is nine-tenths of the law." There is an element of truth to this, but it's not the whole truth. For our purposes, the more important question is, what is meant by "possession"? Its meaning is not intuitively obvious, as a moment's reflection will reveal. For example, you might suppose than you possess something when it is physically within your control, but what do you say when a hurricane deposits a boat onto your land? What if you are not even home when this happens? Do you possess the boat? Ordinarily, we would say that you don't, because you don't have physical control when you are absent. You may not even have the intention to control the boat; perhaps instead of a fancy speedboat in relatively good shape, the boat is a rust bucket badly in need of repair, and you want it removed from your front yard.

Even the element of physical domination of the object may not be necessary. Suppose you give your new class ring to a friend to examine. Is it in the friend's possession? No: the friend has custody, not possession, and you retain the right to permit a second friend to take it from her hands. This is different from the case of a bailment, in which the bailor gives possession of an object to the bailee. For example, a garage (a bailee) entrusted with a car for the evening, and not the owner, has the right to exclude others from the car; the owner could not demand that the garage attendants refrain from moving the car around as necessary.

From these examples, we can see that possession or physical control must usually be understood as the power to exclude others from using the object. Otherwise, anomalies arise from the difficulty of physically controlling certain objects. It is more difficult to exercise control over a one-hundred-foot television antenna than a diamond ring. Moreover, in what sense do you possess your household furniture when you are out of the house? Only, we suggest, in the power to exclude others. But this power is not purely a physical one: being absent from the house, you could not physically restrain anyone. Thus the concept of possession must inevitably be mixed with legal rules that do or could control others.

Possession confers ownership in a restricted class of cases only: when no person was the owner at the time the current owner took the object into his possession. The most obvious categories of objects to which this rule of possession applies are wild animals and abandoned goods. The rule requires that the would-be owner actually take possession of the animal or goods; the hunter who is pursuing a particular wild animal has no legal claim until he has actually captured it. Two hunters are perfectly free to pursue the same animal, and whoever actually grabs it will be the owner.

But even this simple rule is fraught with difficulties in the case of both wild animals and abandoned goods. We examine abandoned goods in Section 29.2.2 "Lost or Misplaced Property". In the case of wild game, fish in a stream, and the like, the general rule is subject to the rights of the owner of the land on which the animals are caught. Thus even if the animals caught by a hunter are wild, as long as they are on another's land, the landowner's rights are superior to the hunter's. Suppose a hunter captures a wild animal, which subsequently escapes, and a second hunter thereafter captures it. Does the first hunter have a claim to the animal? The usual rule is that he does not, for once an animal returns to the wild, ownership ceases.

Lost or Misplaced Property

At common law, a technical distinction arose between lost and misplaced property. An object is lost if the owner inadvertently and unknowingly lets it out of his possession. It is merely misplaced if the owner intentionally puts it down, intending to recover it, even if he subsequently forgets to retrieve it. These definitions are important in considering the old saying "Finders keepers, losers weepers." This is a misconception that is, at best, only partially true, and more often false. The following hierarchy of ownership claims determines the rights of finders and losers.

First, the owner is entitled to the return of the property unless he has intentionally abandoned it. The finder is said to be a quasi-bailee for the true owner, and as bailee she owes the owner certain duties of care. The finder who knows the owner or has reasonable means of discovering the owner's identity commits larceny if she holds on to the object with the intent that it be hers. This rule applies only if the finder actually takes the object into her possession. For example, if you spot someone's wallet on the street you have no obligation to pick it up; but if you do pick it up and see the owner's name in it, your legal obligation is to return it to the rightful owner. The finder who returns the object is not automatically entitled to a reward, but if the loser has offered a reward, the act of returning it constitutes performance of a unilateral contract. Moreover, if the finder has had expenses in connection with finding the owner and returning the property, she is entitled to reasonable reimbursement as a quasi-bailee. But the rights of the owner are frequently subject to specific statutes, such as the one discussed in *Bishop v. Ellsworth* in Section 29.4.1 "Lost or Misplaced Property".

Second, if the owner fails to claim the property within the time allowed by statute or has abandoned it, then the property goes to the owner of the real estate on which it was found if (1) the finder was a trespasser, (2) the goods are found in a private place (though what exactly constitutes a private place is open to question: is the aisle of a grocery store a private place? the back of the food rack? the stockroom?), (3) the goods are buried, or (4) the goods are misplaced rather than lost.

If none of these conditions apply, then the finder is the owner. These rules are considered in the *Bishop* case, (see Section 29.4.1 "Lost or Misplaced Property").

Gift

A gift is a voluntary transfer of property without consideration or compensation. It is distinguished from a sale, which requires consideration. It is distinguished from a promise to give, which is a declaration of an intention to give in the future rather than a present transfer. It is distinguished from a testamentary disposition (will), which takes effect only upon death, not upon the preparation of the documents. Two other distinctions are worth noting. An inter vivos (enter VYE vos) gift is one made between living persons without conditions attached. A causa mortis (KAW zuh mor duz) gift is made by someone contemplating death in the near future.

Requirements

To make an effective gift inter vivos or causa mortis, the law imposes three requirements: (1) the donor must *deliver* a deed or object to the donee; (2) the donor must actually *intend* to make a gift, and (3) the donee must *accept* (Figure 16.2.1).



Figure 16.2.1: Gift Requirements

Delivery

Although it is firmly established that the object be delivered, it is not so clear what constitutes delivery. On the face of it, the requirement seems to be that the object must be transferred to the donee's possession. Suppose your friend tells you he is making a gift to you of certain books that are lying in a locked trunk. If he actually gives you the trunk so that you can carry it away, a gift has been made. Suppose, however, that he had merely given you the key, so that you could come back the next day with your car. If this were the sole key, the courts would probably construe the transfer of the key as possession of the trunk. Suppose, instead, that the books were in a bank vault and the friend made out a legal document giving both you and him the power to take from the bank vault. This would not be a valid gift, since he retained power over the goods.

Intent

The intent to make a gift must be an intent to give the property at the present time, not later. For example, suppose a person has her savings account passbook put in her name and a friend's name, intending that on her death the friend will be able to draw out whatever money is left. She has not made a gift, because she did not intend to give the money when she changed the passbook. The

intent requirement can sometimes be sidestepped if legal title to the object is actually transferred, postponing to the donee only the use or enjoyment of the property until later. Had the passbook been made out in the name of the donee only and delivered to a third party to hold until the death of the donor, then a valid gift may have been made. Although it is sometimes difficult to discern this distinction in practice, a more accurate statement of the rule of intent is this: Intention to give in the future does not constitute the requisite intent, whereas present gifts of future interests will be upheld.

Acceptance

In the usual case, the rule requiring acceptance poses no difficulties. A friend hands you a new book and says, "I would like you to have this." Your taking the book and saying "thank-you" is enough to constitute your acceptance. But suppose that the friend had given you property without your knowing it. For example, a secret admirer puts her stock certificates jointly in your name and hers without telling you. Later, you marry someone else, and she asks you to transfer the certificates back to her name. This is the first you have heard of the transaction. Has a gift been made? The usual answer is that even though you had not accepted the stock when the name change was made, the transaction was a gift that took effect immediately, subject to your right to repudiate when you find out about it. If you do not reject the gift, you have joint rights in the stock. But if you expressly refuse to accept a gift or indicate in some manner that you might not have accepted it, then the gift is not effective. For example, suppose you are running for office. A lobbyist whom you despise gives you a donation. If you refuse the money, no gift has been made.

Gifts Causa Mortis

Even though the requirements of delivery, intent, and acceptance apply to gifts causa mortis as well as inter vivos, a gift causa mortis (one made in contemplation of death) may be distinguished from a gift inter vivos on other grounds. The difference between the two lies in the power of the donor to revoke the gift before he dies; in other words, the gift is conditional on his death. Since the law does not permit gifts that take place in the future contingent on some happening, how can it be that a gift causa mortis is effective? The answer lies in the nature of the transfer: the donee takes actual title when the gift is made; should the donor not in fact die or should he revoke the gift before he dies, then and only then will the donee lose title. The difference is subtle and amounts to the difference between saying "If I die, the watch is yours" and "The watch is yours, unless I survive." In the former case, known as a condition precedent, there is no valid gift; in the latter case, known as a condition subsequent, the gift is valid.

Gifts to Minors

Every state has adopted either the Uniform Gifts to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA), both of which establish the manner by which irrevocable gifts are made to minors. Under these acts, a custodian holds the gifts until the minor reaches the age of eighteen, twenty-one, or twenty-five, depending on state law. Gifts under UGMA are limited for the most part to money or securities, while UTMA allows other types of gifts as well, such as real estate or tangible personal property.

Key Takeaway

Other than outright purchase of personal property, there are various ways in which to acquire legal title. Among these are possession, gift, accession, confusion, and finding property that is abandoned, lost, or mislaid, especially if the abandoned, lost, or mislaid property is found on real property that you own.

Exercises

1. Dan captures a wild boar on US Forest Service land. He takes it home and puts it in a cage, but the boar escapes and runs wild for a few days before being caught by Romero, some four miles distant from Dan's house. Romero wants to keep the boar. Does he "own" it? Or does it belong to Dan, or to someone else?
2. Harriet finds a wallet in the college library, among the stacks. The wallet has $140 in it, but no credit cards or identification. The library has a lost and found at the circulation desk, and the people at the circulation desk are honest and reliable. The wallet itself is unique enough to be identified by its owner. (a) Who owns the wallet and its contents? (b) As a matter of ethics, should Harriet keep the money if the wallet is "legally" hers?

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16.3: Fixtures

Learning Objectives

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

- Know the three tests for when personal property becomes a fixture and thus becomes real property.

Definition

A fixture is an object that was once personal property but that has become so affixed to land or structures that it is considered legally a part of the real property. For example, a stove bolted to the floor of a kitchen and connected to the gas lines is usually considered a fixture, either in a contract for sale, or for testamentary transfer (by will). For tax purposes, fixtures are treated as real property.

Tests

Obviously, no clear line can be drawn between what is and what is not a fixture. In general, the courts look to three tests to determine whether a particular object has become a fixture: annexation, adaptation, and intention (Figure 16.3.2).

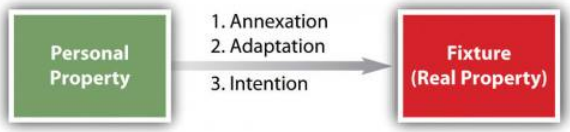


Figure 16.3.2: Fixture Tests

Annexation

The object must be annexed or affixed to the real property. A door on a house is affixed. Suppose the door is broken and the owner has purchased a new door made to fit, but the house is sold before the new door is installed. Most courts would consider that new door a fixture under a rule of constructive annexation. Sometimes courts have said that an item is a fixture if its removal would damage the real property, but this test is not always followed. Must the object be attached with nails, screws, glue, bolts, or some other physical device? In one case, the court held that a four-ton statue was sufficiently affixed merely by its weight. (*Snedeker v. Warring*, 12 N.Y. 170 (1854).)

Adaptation

Another test is whether the object is adapted to the use or enjoyment of the real property. Examples are home furnaces, power equipment in a mill, and computer systems in bank buildings.

Intention

Recent decisions suggest that the controlling test is whether the person who actually annexes the object intends by so doing to make it a permanent part of the real estate. The intention is usually deduced from the circumstances, not from what a person might later say her intention was. If an owner installs a heating system in her house, the law will presume she intended it as a fixture because the installation was intended to benefit the house; she would not be allowed to remove the heating system when she sold the house by claiming that she had not intended to make it a fixture.

Fixture Disputes

Because fixtures have a hybrid nature (once personal property, subsequently real property), they generate a large number of disputes. We have already examined disputes between mortgagees and secured parties. Two other types of disputes are discussed here.

Transfer of Real Estate

When a homeowner sells her house, the problem frequently crops up as to whether certain items in the home have been sold or may be removed by the seller. Is a refrigerator, which simply plugs into the wall, a fixture or an item of personal property? If a dispute

arises, the courts will apply the three tests—annexation, adaptation, and intention. Of course, the simplest way of avoiding the dispute is to incorporate specific reference to questionable items in the contract for sale, indicating whether the buyer or the seller is to keep them.

Tenant's Fixtures

Tenants frequently install fixtures in the buildings they rent or the property they occupy. A company may install tens of thousands of dollars worth of equipment; a tenant in an apartment may bolt a bookshelf into the wall or install shades over a window. Who owns the fixtures when the tenant's lease expires? The older rule was that any fixture, determined by the usual tests, must remain with the landlord. Today, however, certain types of fixtures—known as tenant's fixtures—stay with the tenant. These fall into three categories: (1) trade fixtures—articles placed on the premises to enable the tenant to carry on his or her trade or business in the rented premises; (2) agricultural fixtures—devices installed to carry on farming activities (e.g., milling plants and silos); (3) domestic fixtures—items that make a tenant's personal life more comfortable (carpeting, screens, doors, washing machines, bookshelves, and the like).

The three types of tenant's fixtures remain personal property and may be removed by the tenant if the following three conditions are met: (1) They must be installed for the requisite purposes of carrying on the trade or business or the farming or agricultural pursuits or for making the home more comfortable, (2) they must be removable without causing substantial damage to the landlord's property, and (3) they must be removed before the tenant turns over possession of the premises to the landlord. Again, any debatable points can be resolved in advance by specifying them in the written lease.

Key Takeaway

Personal property is often converted to real property when it is affixed to real property. There are three tests that courts use to determine whether a particular object has become a fixture and thus has become real property: annexation, adaptation, and intention. Disputes over fixtures often arise in the transfer of real property and in landlord-tenant relations.

Exercises

1. Jim and Donna Stoner contract to sell their house in Rochester, Michigan, to Clem and Clara Hovenkamp. Clara thinks that the decorative chandelier in the entryway is lovely and gives the house an immediate appeal. The chandelier was a gift from Donna's mother, "to enhance the entryway" and provide "a touch of beauty" for Jim and Donna's house. Clem and Clara assume that the chandelier will stay, and nothing specific is mentioned about the chandelier in the contract for sale. Clem and Clara are shocked when they move in and find the chandelier is gone. Have Jim and Donna breached their contract of sale?
2. Blaine Goodfellow rents a house from Associated Properties in Abilene, Texas. He is there for two years, and during that time he installs a ceiling fan, custom-builds a bookcase for an alcove on the main floor, and replaces the screening on the front and back doors, saving the old screening in the furnace room. When his lease expires, he leaves, and the bookcase remains behind. Blaine does, however, take the new screening after replacing it with the old screening, and he removes the ceiling fan and puts back the light. He causes no damage to Associated Properties' house in doing any of this. Discuss who is the rightful owner of the screening, the bookcase, and the ceiling fan after the lease expires.

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16.4: Summary and Exercises

Summary

Property is the *legal relationship* between persons with respect to things. The law spells out what can be owned and the degree to which one person can assert an interest in someone else's things. Property is classified in several ways: personal versus real, tangible versus intangible, private versus public. The first distinction, between real and personal, is the most important, for different legal principles often apply to each. Personal property is movable, whereas real property is immovable.

Among the ways personal property can be acquired are: by (1) possession, (2) finding, (3) gift, (4) accession, and (5) confusion.

Possession means the power to exclude others from using an object. Possession confers ownership only when there is no owner at the time the current owner takes possession. "Finders keepers, losers weepers" is not a universal rule; the previous owner is entitled to return of his goods if it is reasonably possible to locate him. If not, or if the owner does not claim his property, then it goes to the owner of the real estate on which it was found, if the finder was a trespasser, or the goods were buried, were in a private place, or were misplaced rather than lost. If none of these conditions applies, the property goes to the finder.

A gift is a voluntary transfer of property without consideration. Two kinds of gifts are possible: inter vivos and causa mortis. To make an effective gift, (1) the donor must make out a deed or physically deliver the object to the donee, (2) the donor must intend to make a gift, and (3) the donee must accept the gift. Delivery does not always require physical transfer; sometimes, surrender of control is sufficient. The donor must intend to give the gift now, not later.

Accession is an addition to that which is already owned—for example, the birth of calves to a cow owned by a farmer. But when someone else, through labor or by supplying material, adds value, the accession goes to the owner of the principal goods.

Confusion is the intermingling of like goods so that each, while maintaining its form, becomes a part of a larger whole, like grain mixed in a silo. As long as the goods are identical, they can easily enough be divided among their owners.

A fixture is a type of property that ceases to be personal property and becomes real property when it is annexed or affixed to land or buildings on the land and adapted to the use and enjoyment of the real property. The common-law rules governing fixtures do not employ clear-cut tests, and sellers and buyers can avoid many disputes by specifying in their contracts what goes with the land. Tenant's fixtures remain the property of the tenant if they are for the convenience of the tenant, do not cause substantial damage to the property when removed, and are removed before possession is returned to the landlord.

Exercises

1. Kate owns a guitar, stock in a corporation, and an antique bookcase that is built into the wall of her apartment. How would you classify each kind of property?
2. After her last business law class, Ingrid casually throws her textbook into a trash can and mutters to herself, "I'm glad I don't have to read that stuff anymore." Tom immediately retrieves the book from the can. Days later, Ingrid realizes that the book will come in handy, sees Tom with it, and demands that he return the book. Tom refuses. Who is entitled to the book? Why?
3. In Exercise 2, suppose that Ingrid had accidentally left the book on a table in a restaurant. Tom finds it, and chanting "Finders keepers, losers weepers," he refuses to return the book. Is Ingrid entitled to the book? Why?
4. In Exercise 3, if the owner of the book (Ingrid) is never found, who is entitled to the book—the owner of the restaurant or Tom? Why?
5. Matilda owned an expensive necklace. On her deathbed, Matilda handed the necklace to her best friend, Sadie, saying, "If I die, I want you to have this." Sadie accepted the gift and placed it in her safe-deposit box. Matilda died without a will, and now her only heir, Ralph, claims the necklace. Is he entitled to it? Why or why not?

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CHAPTER OVERVIEW

17: Intellectual Property

Learning Objectives

After reading this chapter, you should understand the following:

- The principal kinds of intellectual property
- The difference between patents and trade secrets, and why a company might choose to rely on trade secrets rather than obtain a patent
- What copyrights are, how to obtain them, and how they differ from trademarks
- Why some “marks” may not be eligible for trademark protection, and how to obtain trademark protection for those that are

17.1: Introduction to Intellectual Property

17.2: Patents

17.3: Trade Secrets

17.4: Copyright

17.5: Trademarks

17.6: Summary and Exercises

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17.1: Introduction to Intellectual Property

Many businesses would be challenging in operating without being able to protect their rights to a particular type of intangible personal property: intellectual property. The major forms of intellectual property are patents, copyrights, and trademarks. Unlike tangible personal property (machines, inventory) or real property (land, office buildings), intellectual property is formless. It is the product of the human intellect that is embodied in the goods and services a company offers and by which the company is known.

A patent is a grant from government that gives an inventor the exclusive right to make, use, and sell an invention for a period of twenty years from the date of filing the application for a patent. A copyright is the right to exclude others from using or marketing forms of expression. A trademark is the right to prevent others from using a company's product name, slogan, or identifying design. Other forms of intellectual property are trade secrets (particular kinds of information of commercial use to a company that created it) and right of publicity (the right to exploit a person's name or image). Note that the property interest protected in each case is not the tangible copy of the invention or writing—not the machine with a particular serial number or the book lying on someone's shelf—but the invention or words themselves. That is why intellectual property is said to be intangible: it is a right to exclude any others from gaining economic benefit from your own intellectual creation. In this chapter, we examine how Congress, the courts, and the Patent and Trademark Office have worked to protect the major types of intellectual property.

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17.2: Patents

Learning Objectives

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

- Explain why Congress would grant exclusive monopolies (patents) for certain periods of time.
- Describe what kinds of things may be patentable and what kinds of things may not be patentable.
- Explain the procedures for obtaining a patent, and how patent rights may be an issue where the invention is created by an employee.
- Understand who can sue for patent infringement, on what basis, and with what potential remedies.

Source of Authority and Duration

Patent and copyright law are federal, enacted by Congress under the power given by Article I of the Constitution "to promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries." Under current law, a patent gives an inventor exclusive rights to make, use, or sell an invention for twenty years. (If the patent is a design patent—protecting the appearance rather than the function of an item—the period is fourteen years.) In return for this limited monopoly, the inventor must fully disclose, in papers filed in the US Patent and Trademark Office (PTO), a complete description of the invention.

Patentability

What May Be Patented

The patent law says that "any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof" may be patented.35 United States Code, Section 101. A process is a "process, art or method, and includes a new use of a known process, machine, manufacture, composition of matter, or material."35 United States Code, Section 101. A process for making rolled steel, for example, qualifies as a patentable process under the statute. A machine is a particular apparatus for achieving a certain result or carrying out a distinct process—lathes, printing presses, motors, and the cotton gin are all examples of the hundreds of thousands of machines that have received US patents since the first Patent Act in 1790. A manufacture is an article or a product, such as a television, an automobile, a telephone, or a lightbulb. A composition of matter is a new arrangement of elements so that the resulting compound, such as a metal alloy, is not found in nature. In *Commissioner of Patents v. Chakrabarty*, 444 U.S. 1028 (1980). the Supreme Court said that even living organisms—in particular, a new "genetically engineered" bacterium that could "eat" oil spills—could be patented. The *Chakrabarty* decision has spawned innovation: a variety of small biotechnology firms have attracted venture capitalists and other investors.

According to the PTO, gene sequences are patentable subject matter, provided they are isolated from their natural state and processed in a way that separates them from other molecules naturally occurring with them. Gene patenting, always controversial, generated new controversy when the PTO issued a patent to Human Genome Sciences, Inc. for a gene found to serve as a platform from which the AIDS virus can infect cells of the body. Critics faulted the PTO for allowing "ownership" of a naturally occurring human gene and for issuing patents without requiring a showing of the gene's utility. New guidelines from the PTO followed in 2000; these focused on requiring the applicant to make a strong showing on the utility aspect of patentability and somewhat diminished the rush of biotech patent requests.

There are still other categories of patentable subjects. An improvement is an alteration of a process, machine, manufacture, or composition of matter that satisfies one of the tests for patentability given later in this section. New, original ornamental designs for articles of manufacture are patentable (e.g., the shape of a lamp); works of art are not patentable but are protected under the copyright law. New varieties of cultivated or hybridized plants are also patentable, as are genetically modified strains of soybean, corn, or other crops.

What May Not Be Patented

Many things can be patented, but not (1) the laws of nature, (2) natural phenomena, and (3) abstract ideas, including algorithms (step-by-step formulas for accomplishing a specific task).

One frequently asked question is whether patents can be issued for computer software. The PTO was reluctant to do so at first, based on the notion that computer programs were not "novel"—the software program either incorporated automation of manual processes or used mathematical equations (which were not patentable). But in 1998, the Supreme Court held in*Diamond v. Diehr*, 450 U.S. 175 (1981). that patents could be obtained for a process that incorporated a computer program if the process itself was patentable.

A business process can also be patentable, as the US Court of Appeals for the Federal Circuit ruled in 1998 in *State Street Bank and Trust v. Signature Financial Group, Inc.*, 149 F.3d 1368 (Fed. Cir. 1998). Signature Financial had a patent for a computerized accounting system that determined share prices through a series of mathematical calculations that would help manage mutual funds. State Street sued to challenge that patent. Signature argued that its model and process was protected, and the court of appeals upheld it as a "practical application of a mathematical, algorithm, formula, or calculation," because it produces a "useful, concrete and tangible result." Since *State Street*, many other firms have applied for business process patents. For example, Amazon.com obtained a business process patent for its "one-click" ordering system, a method of processing credit-card orders securely. (But see *Amazon.com v. Barnesandnoble.com, Inc.*, 239 F.3d 1343 (Fed. Cir. 2001). in which the court of appeals rejected Amazon's challenge to Barnesandnoble.com using its Express Land one-click ordering system.)

Tests for Patentability

Just because an invention falls within one of the categories of patentable subjects, it is not necessarily patentable. The Patent Act and judicial interpretations have established certain tests that must first be met. To approve a patent application, the PTO (as part of the Department of Commerce) will require that the invention, discovery, or process be novel, useful, and nonobvious in light of current technology.

Perhaps the most significant test of patentability is that of obviousness. The act says that no invention may be patented "if the differences between the subject matter sought to be patented and the prior art are such that the subject matter as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art to which said subject matter pertains." This provision of the law has produced innumerable court cases, especially over improvement patents, when those who wish to use an invention on which a patent has been issued have refused to pay royalties on the grounds that the invention was obvious to anyone who looked.

Procedures for Obtaining a Patent

In general, the United States (unlike many other countries) grants a patent right to the first person to invent a product or process rather than to the first person to file for a patent on that product or process. As a practical matter, however, someone who invents a product or process but does not file immediately should keep detailed research notes or other evidence that would document the date of invention. An inventor who fails to apply for a patent within a year of that date would forfeit the rights granted to an inventor who had published details of the invention or offered it for sale. But until the year has passed, the PTO may not issue a patent to X if Y has described the invention in a printed publication here or abroad or the invention has been in public use or on sale in this country.

An inventor cannot obtain a patent automatically; obtaining a patent is an expensive and time-consuming process, and the inventor will need the services of a patent attorney, a highly specialized practitioner. The attorney will help develop the required specification, a description of the invention that gives enough detail so that one skilled in the art will be able to make and use the invention. After receiving an application, a PTO examiner will search the records and accept or reject the claim. Usually, the attorney will negotiate with the examiner and will rewrite and refine the application until it is accepted. A rejection may be appealed, first to the PTO's Board of Appeals and then, if that fails, to the federal district court in the District of Columbia or to the US Court of Appeals for the Federal Circuit, the successor court to the old US Court of Customs and Patent Appeals.

Once a patent application has been filed, the inventor or a company to which she has assigned the invention may put the words "patent pending" on the invention. These words have no legal effect. Anyone is free to make the invention as long as the patent has not yet been issued. But they do put others on notice that a patent has been applied for. Once the patent has been granted, infringers may be sued even if the infringed has made the product and offered it for sale before the patent was granted.

In today's global market, obtaining a US patent is important but is not usually sufficient protection. The inventor will often need to secure patent protection in other countries as well. Under the Paris Convention for the Protection of Industrial Property (1883),

parties in one country can file for patent or trademark protection in any of the other member countries (181 countries as of 2026). The World Trade Organization's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) established standards for protecting intellectual property rights (patents, trademarks, and copyrights) and provides that each member nation must have laws that protect intellectual property rights with effective access to judicial systems for pursuing civil and criminal penalties for violations of such rights.

Patent Ownership

The patent holder is entitled to make and market the invention and to exclude others from doing so. Because the patent is a species of property, it may be transferred. The inventor may assign part or all of his interest in the patent or keep the property interest and license others to manufacture or use the invention in return for payments known as royalties. The license may be exclusive with one licensee, or the inventor may license many to exploit the invention. One important limitation on the inventor's right to the patent interest is the so-called shop right. This is a right created by state courts on equitable grounds giving employers a nonexclusive royalty-free license to use any invention made by an employee on company time and with company materials. The shop right comes into play only when a company has no express or implied understanding with its employees. Most corporate laboratories have contractual agreements with employees about who owns the invention and what royalties will be paid.

Infringement and Invalidity Suits

Suits for patent infringement can arise in three ways: (1) the patent holder may seek damages and an injunction against the infringer in federal court, requesting damages for royalties and lost profits as well; (2) even before being sued, the accused party may take the patent holder to court under the federal Declaratory Judgment Act, seeking a court declaration that the patent is invalid; (3) the patent holder may sue a licensee for royalties claimed to be due, and the licensee may counterclaim that the patent is invalid. Such a suit, if begun in state court, may be removed to federal court.

In a federal patent infringement lawsuit, the court may grant the winning party reimbursement for attorneys' fees and costs. If the infringement is adjudged to be intentional, the court can triple the amount of damages awarded. Prior to 2006, courts were typically granting permanent injunctions to prevent future infringement. Citing *eBay, Inc. v. Merc Exchange, LLC*, 546 U.S. 388 (2006). the Supreme Court ruled that patent holders are not automatically entitled to a permanent injunction against infringement during the life of the patent. Courts have the discretion to determine whether justice requires a permanent injunction, and they may conclude that the public interest and equitable principles may be better satisfied with compensatory damages only.

Proving infringement can be a difficult task. Many companies employ engineers to "design around" a patent product—that is, to seek ways to alter the product to such an extent that the substitute product no longer consists of enough of the elements of the invention safeguarded by the patent. However, infringing products, processes, or machines need not be identical; as the Supreme Court said in *Sanitary Refrigerator Co. v. Winers*, 280 U.S. 30 (1929). "one device is an infringement of another…if two devices do the same work in substantially the same way, and accomplish substantially the same result…even though they differ in name, form, or shape." This is known as the doctrine of equivalents. In an infringement suit, the court must choose between these two extremes: legitimate "design around" and infringement through some equivalent product.

An infringement suit can often be dangerous because the defendant will almost always assert in its answer that the patent is invalid. The plaintiff patent holder thus runs the risk that his entire patent will be taken away from him if the court agrees. In ruling on validity, the court may consider all the tests, such as prior art and obviousness, discussed in Section 30.1.2 "Patentability" and rule on these independently of the conclusions drawn by the PTO.

Patent Misuse

Although a patent is a monopoly granted to the inventor or his assignee or licensee, the monopoly power is legally limited. An owner who misuses the patent may find that he will lose an infringement suit. One common form of misuse is to tie the patented good to some unpatented one—for example, a patented movie projector that will not be sold unless the buyer agrees to rent films supplied only by the manufacturer of the movie projector, or a copier manufacturer that requires buyers to purchase plain paper from it. As we will see in Chapter 26, various provisions of the federal antitrust laws, including, specifically, Section 3 of the Clayton Act, outlaw certain kinds of tying arrangements. Another form of patent misuse is a provision in the licensing agreement

prohibiting the manufacturer from also making competing products. Although the courts have held against several other types of misuse, the general principle is that the owner may not use his patent to restrain trade in unpatented goods.

Key Takeaway

Many different “things” are patentable, include gene sequences, business processes, and any other “useful invention.” The US Patent and Trademark Office acts on initial applications and may grant a patent to an applicant. The patent, which allows a limited-time monopoly, is for twenty years. The categories of patentable things include processes, machines, manufactures, compositions of matter, and improvements. Ideas, mental processes, naturally occurring substances, methods of doing business, printed matter, and scientific principles cannot be patented. Patent holders may sue for infringement and royalties from an infringer user.

Exercises

1. Calera, Inc. discovers a way to capture carbon dioxide emissions at a California power plant and use them to make cement. This is a win for the power company, which needs to reduce its carbon dioxide emissions, and a win for Calera. Calera decides to patent this invention. What kind of patent would this be? A machine? A composition of matter? A manufacture?
2. In your opinion, what is the benefit of allowing companies to isolate genetic material and claim a patent? What kind of patent would this be? A machine? A composition of matter? A manufacture?
3. How could a “garage inventor,” working on her own, protect a patentable invention while yet demonstrating it to a large company that could bring the invention to market?

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17.3: Trade Secrets

Learning Objectives

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

- Describe the difference between trade secrets and patents, and explain why a firm might prefer keeping a trade secret rather than obtaining a patent.
- Understand the dimensions of corporate espionage and the impact of the federal Economic Espionage Act.

Definition of Trade Secrets

A patent is an invention publicly disclosed in return for a monopoly. A trade secret is a means to a monopoly that a company hopes to maintain by preventing public disclosure. Why not always take out a patent? There are several reasons. The trade secret might be one that is not patentable, such as a customer list or an improvement that does not meet the tests of novelty or nonobviousness. A patent can be designed around; but if the trade secret is kept, its owner will be the exclusive user of it. Patents are expensive to obtain, and the process is extremely time consuming. Patent protection expires in twenty years, after which anyone is free to use the invention, but a trade secret can be maintained for as long as the secret is kept.

However, a trade secret is valuable only so long as it is kept secret. Once it is publicly revealed, by whatever means, anyone is free to use it. The critical distinction between a patent and a trade secret is this: a patent gives its owner the right to enjoin anyone who infringes it from making use of it, whereas a trade secret gives its "owner" the right to sue only the person who improperly took it or revealed it.

According to the Restatement of Torts, Section 757, Comment b, a trade secret may consist of any formula, pattern, device or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it. It may be a formula for a chemical compound, a process of manufacturing, treating or preserving materials, a pattern for a machine or other device, or a list of customers.…A trade secret is a process or device for continuous use in the operation of a business. Generally it relates to the production of goods, as, for example, a machine or formula for the production of an article.

Other types of trade secrets are customer information, pricing data, marketing methods, sources of supply, and secret technical know-how.

Elements of Trade Secrets

To be entitled to protection, a trade secret must be (1) original and (2) secret.

Originality

The trade secret must have a certain degree of originality, although not as much as would be necessary to secure a patent. For example, a principle or technique that is common knowledge does not become a protectable trade secret merely because a particular company taught it to one of its employees who now wants to leave to work for a competitor.

Secrecy

Some types of information are obviously secret, like the chemical formula that is jealously guarded through an elaborate security system within the company. But other kinds of information might not be secret, even though essential to a company's business. For instance, a list of suppliers that can be devised easily by reading through the telephone directory is not secret. Nor is a method secret simply because someone develops and uses it, if no steps are taken to guard it. A company that circulates a product description in its catalog may not claim a trade secret in the design of the product if the description permits someone to do "reverse engineering." A company that hopes to keep its processes and designs secret should affirmatively attempt to do so—for example, by requiring employees to sign a nondisclosure agreement covering the corporate trade secrets with which they work. However, a company need not go to every extreme to guard a trade secret.

Trade-secrets espionage has become a big business. To protect industrial secrets, US corporations spend billions on security arrangements. The line between competitive intelligence gathering and espionage can sometimes be difficult to draw. The problem is by no means confined to the United States; companies and nations all over the world have become concerned about theft of trade secrets to gain competitive advantage, and foreign governments are widely believed to be involved in espionage and cyberattacks.

Economic Espionage Act

The Economic Espionage Act (EEA) of 1996 makes the theft or misappropriation of a trade secret a federal crime. The act is aimed at protecting commercial information rather than classified national defense information. Two sorts of activities are criminalized. The first section of the act Economic Espionage Act, 18 United States Code, Section 1831(a) (1996) criminalizes the misappropriation of trade secrets (including conspiracy to misappropriate trade secrets and the subsequent acquisition of such misappropriated trade secrets) with the knowledge or intent that the theft will benefit a foreign power. Penalties for violation are fines of up to US $500,000 per offense and imprisonment of up to fifteen years for individuals, and fines of up to US$10 million for organizations.

The EEA is limited to the United States and has no extraterritorial application unless (1) the offender is a US company or a citizen operating from abroad against a US company or (2) an act in furtherance of the espionage takes place in the United States. Other nations lack such legislation, and some may actively support industrial espionage using both their national intelligence services. The US Office of the National Counterintelligence Executive publishes an annual report, mandated by the US Congress, on foreign economic collection and industrial espionage, which outlines these espionage activities of many foreign nations.

Right of Employees to Use Trade Secrets

A perennial source of lawsuits in the trade secrets arena is the employee who is hired away by a competitor, allegedly taking trade secrets along with him. Companies frequently seek to prevent piracy by requiring employees to sign confidentiality agreements. An agreement not to disclose particular trade secrets learned or developed on the job is generally enforceable. Even without an agreement, an employer can often prevent disclosure under principles of agency law. Sections 395 and 396 of the Restatement (Second) of Agency suggest that it is an actionable breach of duty to disclose to third persons information given confidentially during the course of the agency. However, every person is held to have a right to earn a living. If the rule were strictly applied, a highly skilled person who went to another company might be barred from using his knowledge and skills. The courts do not prohibit people from using elsewhere the general knowledge and skills they developed on the job. Only specific trade secrets are protected.

To get around this difficulty, some companies require their employees to sign agreements not to compete. But unless the agreements are limited in scope and duration to protect a company against only specific misuse of trade secrets, they are unenforceable.

Key Takeaway

Trade secrets, if they can be kept, have indefinite duration and thus greater potential value than patents. Trade secrets can be any formula, pattern, device, process, or compilation of information to be used in a business. Customer information, pricing data, marketing methods, sources of supply, and technical know-how could all be trade secrets. State law has protected trade secrets, and federal law has provided criminal sanctions for theft of trade secrets. With the importance of digitized information, methods of theft now include computer hacking; theft of corporate secrets is a burgeoning global business that often involves cyberattacks.

Exercises

1. Wu Dang, based in Hong Kong, hacks into the Hewlett-Packard database and “steals” plans and specifications for HP’s latest products. The HP server is located in the United States. He sells this information to a Chinese company in Shanghai. Has he violated the US Economic Espionage Act?
2. What are the advantages of keeping a formula as a trade secret rather than getting patent protection?

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17.4: Copyright

Learning Objectives

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

- Describe and explain copyrights, how to obtain one, and how they differ from trademarks.
- Explain the concept of fair use and describe its limits.

Definition and Duration

Copyright is the legal protection given to "authors" for their "writings." Copyright law is federal; like patent law, its source lies in the Constitution. Copyright protects the expression of ideas in some tangible form, but it does not protect the ideas themselves. Under the 1976 Copyright Act as amended, a copyright in any work created after January 1, 1978, begins when the work is fixed in tangible form—for example, when a book is written down or a picture is painted—and generally lasts for the life of the author plus 70 years after his or her death. This is similar to copyright protection in many countries, but in some countries, the length of copyright protection is the life of the author plus 50 years. For copyrights owned by publishing houses, done as works for hire, common copyright expires 95 years from the date of publication or 120 years from the date of creation, whichever is first. For works created before 1978, such as many of Walt Disney's movies and cartoons, the US Sonny Bono Copyright Term Extension Act of 1998 provided additional protection of up to 95 years from publication date. Thus works created in 1923 by Disney would not enter the public domain until 2019 or after, unless the copyright had expired prior to 1998 or unless the Disney company released the work into the public domain. In general, after expiration of the copyright, the work enters the public domain.

In 1989, the United States signed the Berne Convention, an international copyright treaty. This law eliminated the need to place the symbol © or the word *Copyright* or the abbreviation *Copr.* on the work itself. Copyrights can be registered with the US Copyright Office in Washington, DC.

Protected Expression

The Copyright Act protects a variety of "writings," some of which may not seem written at all. These include literary works (books, newspapers, and magazines), music, drama, choreography, films, art, sculpture, and sound recordings. Since copyright covers the expression and not the material or physical object, a book may be copyrighted whether it is on paper, microfilm, tape, or computer disk.

Rights Protected by the Copyright Act

Preventing Copying

A copyright gives its holder the right to prevent others from copying his or her work. The copyright holder has the exclusive right to reproduce the work in any medium (paper, film, sound recording), to perform it (e.g., in the case of a play), or to display it (a painting or film). A copyright also gives its holder the exclusive right to prepare derivative works based on the copyrighted work. Thus a playwright could not adapt to the stage a novelist's book without the latter's permission.

Fair Use

One major exception to the exclusivity of copyrights is the fair use doctrine. Section 107 of the Copyright Act provides as follows:

Fair use of a copyrighted work, including such use by reproduction in copies or phonorecords or by any other means specified by section 106 of the copyright, for purposes such as criticism, comment, news reporting, teaching (including multiple copies for classroom use), scholarship, or research, is not an infringement of copyright. In determining whether the use made of a work in any particular case is a fair use, the factors to be considered shall include–

(1) the purpose and character of the use, including whether such use is of a commercial nature or is for nonprofit educational purposes;

(2) the nature of the copyrighted work;

(3) the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and

(4) the effect of the use upon the potential market for or value of the copyrighted work.17 United States Code, Section 107.

These are broad guidelines. Accordingly, any copying could be infringement, and fair use could become a question of fact on a case-by-case basis. In determining fair use, however, courts have often considered the fourth factor (effect of the use upon the potential market for the copyrighted work) to be the most important.

Clear examples of fair use would be when book reviewers or writers quote passages from copyrighted books. Without fair use, most writing would be useless because it could not readily be discussed. But the doctrine of fair use grew more troublesome with the advent of plain-paper copiers and is now even more troublesome with electronic versions of copyrighted materials that are easily copied and distributed. The 1976 act took note of the new copier technology, listing “teaching (including multiple copies for classroom use)” as one application of fair use. The Copyright Office follows guidelines specifying just how far the copying may go —for example, multiple copies of certain works may be made for classroom use, but copies may not be used to substitute for copyrighted anthologies.

Infringement

Verbatim use of a copyrighted work is easily provable. The more difficult question arises when the copyrighted work is altered in some way. As in patent law, the standard is one of substantial similarity.

Copyrightability Standards

To be subject to copyright, the writing must be “fixed” in some “tangible medium of expression.” A novelist who composes a chapter of her next book in her mind and tells it to a friend before putting it on paper could not stop the friend from rushing home, writing it down, and selling it (at least the federal copyright law would offer no protection; some states might independently offer a legal remedy, however).

The work also must be creative, at least to a minimal degree. Words and phrases, such as names, titles, and slogans, are not copyrightable; nor are symbols or designs familiar to the public. But an author who contributes her own creativity—like taking a photograph of nature—may copyright the resulting work, even if the basic elements of the composition were not of her making.

Finally, the work must be “original,” which means simply that it must have originated with the author. The law does not require that it be novel or unique. This requirement was summarized pithily by Judge Learned Hand: “If by some magic a man who had never known it were to compose anew Keats’s Ode on a Grecian Urn, he would be an author, and, if he copyrighted it, others might not copy that poem, though they might of course copy Keats’s.”*Sheldon v. Metro-Goldwyn Pictures Corp.*, 81 F.2d 49 (2d Cir. 1936). Sometimes the claim is made that a composer, for example, just happened to compose a tune identical or strikingly similar to a copyrighted song; rather than assume the unlikely coincidence that Judge Hand hypothesized, the courts will look for evidence that the alleged copier had access to the copyrighted song. If he did—for example, the song was frequently played on the air—he cannot defend the copying with the claim that it was unconscious, because the work would not then have been original.

Section 102 of the Copyright Act excludes copyright protection for any “idea, procedure, process, system, method of operation, concept, principle, or discovery, regardless of the form in which it is described, explained, illustrated, or embodied.”17 United States Code, Section 102.

Einstein copyrighted books and monographs he wrote on the theory of relativity, but he could not copyright the famous formula $E = mc^2$, nor could he prevent others from writing about the theory. But he could protect the particular way in which his ideas were expressed. In general, facts widely known by the public are not copyrightable, and mathematical calculations are not copyrightable. Compilations of facts may be copyrightable, if the way that they are coordinated or arranged results in a work that shows some originality. For example, compiled information about yachts listed for sale may qualify for copyright protection. (*BUC International Corp. v. International Yacht Council, Ltd.*, 489 F.3d 1129 (11th Cir. 2007).)

One of the most troublesome recent questions concerning expression versus ideas is whether a computer program may be copyrighted. After some years of uncertainty, the courts have accepted the copyrightability of computer programs. (*Apple Computer, Inc. v. Franklin Computer Corp.*, 714 F.2d 1240 (3d Cir. 1983).) In *Thaler v. Perlmutter*, 23-5233 (D.C.Cir. 2025) an appellate court held that the Copyright Act does not protect work created by Artificial Intelligence ("AI")--protection is only provided for work created by humans in the first instance.

How far the copyright law will protect particular software products is a hotly debated topic, sparked by a federal district court's ruling in 1990 that the "look and feel" of Lotus 1-2-3's menu system is copyrightable and was in fact infringed by Paperback Software's VP-Planner, a competing spreadsheet.*Lotus Development Corp. v. Paperback Software International*, 740 F.Supp. 37 (D. Mass. 1990). The case has led some analysts to "fear that legal code, rather than software code, is emerging as the factor that will determine which companies and products will dominate the 1990s."Peter H. Lewis, "When Computing Power Is Generated by the Lawyers," *New York Times*, July 22 1990.

Who May Obtain a Copyright?

With one important exception, only the author may hold the initial copyright, although the author may assign it or license any one or more of the rights conveyed by the copyright. This is a simple principle when the author has written a book or painted a picture. But the law is unclear in the case of a motion picture or a sound recording. Is the author the script writer, the producer, the performer, the director, the engineer, or someone else? As a practical matter, all parties involved spell out their rights by contract.

The exception, which frequently covers the difficulties just enumerated, is for works for hire. Any person employed to write—a journalist or an advertising jingle writer, for example—is not the "author." For purposes of the statute, the employer is the author and may take out the copyright. When the employee is in fact an "independent contractor" and the work in question involves any one of nine types (book, movies, etc.) spelled out in the Copyright Act, the employer and the creator must spell out their entitlement to the copyright in a written agreement. (*Community for Creative Non-Violence v. Reid*, 109 S.Ct. 2166 (1989).)

Obtaining a Copyright

Until 1978, a work could not be copyrighted unless it was registered in the Copyright Office or was published and unless each copy of the work carried a copyright notice, consisting of the word *Copyright*, the abbreviation *Copr.*, or the common symbol ©, together with the date of first publication and the name of the copyright owner. Under the 1976 act, copyright became automatic whenever the work was fixed in a tangible medium of expression (e.g., words on paper, images on film or videotape, sound on tape or compact disc), even if the work remained unpublished or undistributed. However, to retain copyright protection, the notice had to be affixed once the work was "published" and copies circulated to the public. After the United States entered the Berne Convention, an international treaty governing copyrights, Congress enacted the Berne Implementation Act, declaring that, effective in 1989, notice, even after publication, was no longer required.

Notice does, however, confer certain benefits. In the absence of notice, a copyright holder loses the right to receive statutory damages (an amount stated in the Copyright Act and not required to be proved) if someone infringes the work. Also, although it is no longer required, an application and two copies of the work (for deposit in the Library of Congress) filed with the Copyright Office, in Washington, DC, will enable the copyright holder to file suit should the copyright be infringed. Unlike patent registration, which requires elaborate searching of Patent and Trademark Office (PTO) records, copyright registration does not require a reading of the work to determine whether it is an original creation or an infringement of someone else's prior work. But copyright registration does not immunize the holder from an infringement suit. If a second work has been unlawfully copied from an earlier work, the second author's copyright will not bar the infringed author from collecting damages and obtaining an injunction.

Computer Downloads and the Digital Millennium Copyright Act

The ubiquity of the Internet and the availability of personal computers with large capacities have greatly impacted the music business. Sharing of music files took off in the late 1990s with Napster, which lost a legal battle on copyright and had to cease doing business. By providing the means by which individuals could copy music that had been purchased, major record labels were losing substantial profits. Grokster, a privately owned software company based in the West Indies, provided peer-to-peer file sharing from 2001 to 2005 until the US Supreme Court's decision in *MGM Studios, Inc. v. Grokster, Ltd.*, 545 U.S. 913 (2005).

For computers with the Microsoft operating system, the Court disallowed the peer-to-peer file sharing, even though Grokster claimed it did not violate any copyright laws because no files passed through its computers. (Grokster had assigned certain user computers as "root supernodes" that acted as music hubs for the company and was not directly involved in controlling any specific music-file downloads.)

Grokster had argued, based on *Sony v. Universal Studios*, *Sony v. Universal Studios*, 464 U.S. 417 (1984) that the sale of its copying equipment (like the Betamax videocassette recorders at issue in that case) did not constitute contributory infringement "if the product is widely used for legitimate, unobjectionable purposes." Plaintiffs successfully argued that the Sony safe-harbor concept requires proof that the noninfringing use is the primary use in terms of the product's utility.

The Digital Millennium Copyright Act (DMCA), passed into law in 1998, implements two 1996 treaties of the World Intellectual Property Organization. It criminalizes production and sale of devices or services intended to get around protective measures that control access to copyrighted works. In addition, the DMCA heightens the penalties for copyright infringement on the Internet. The DMCA amended Title 17 of the United States Code to extend the reach of copyright, while limiting the liability of the providers of online services for copyright infringement by their users.

Key Takeaway

Copyright is the legal protection given to "authors" for their "writings." It protects ideas in fixed, tangible form, not ideas themselves. Copyright protection can extend as long as 120 years from the date of creation or publication. Expression found in literary works, music, drama, film, art, sculpture, sound recordings, and the like may be copyrighted. The fair use doctrine limits the exclusivity of copyright in cases where scholars, critics, or teachers use only selected portions of the copyrighted material in a way that is unlikely to affect the potential market for or value of the copyrighted work.

Exercises

1. Explain how a list could be copyrightable.
2. An author wrote a novel, *Brunch at Bruno's*, in 1961. She died in 1989, and her heirs now own the copyright. When do the rights of the heirs come to an end? That is, when does *Brunch at Bruno's* enter the public domain?
3. Keith Bradsher writes a series of articles on China for the *New York Times* and is paid for doing so. Suppose he wants to leave the employ of the *Times* and be a freelance writer. Can he compile his best articles into a book, *Changing Times in China*, and publish it without the *New York Times*'s permission? Does it matter that he uses the word *Times* in his proposed title?
4. What kind of file sharing of music is now entirely legal? Shaunese Collins buys a Yonder Mountain String Band CD at a concert at Red Rocks in Morrison, Colorado. With her iMac, she makes a series of CDs for her friends. She does this six times. Has she committed six copyright violations?

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17.5: Trademarks

Learning Objectives

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

- Understand what a trademark is and why it deserves protection.
- Know why some “marks” may not be eligible for trademark protection, and how to obtain trademark protection for those that are.
- Explain what “blurring” and “tarnishment” are and what remedies are available to the holder of the mark.

Definitions of Trademarks

A trademark is defined in the federal Lanham Act of 1946 as “any word, name, symbol, or device or any combination thereof adopted and used by a manufacturer or merchant to identify his goods and distinguish them from goods manufactured or sold by others.”15 United States Code, Section 1127.

Examples of well-known trademarks are Coca-Cola, Xerox, and Apple. A service mark is used in the sale or advertising of services to identify the services of one person and distinguish them from the services of others. Examples of service marks are McDonald’s, BP, and Hilton. A certification mark is used in connection with many products “to certify regional or other origin, material, mode of manufacture, quality, accuracy or other characteristics of such goods or services or that the work or labor on the goods or services was performed by members of a union or other organization.” Examples are the Good Housekeeping Seal of Approval and UL (Underwriters Laboratories, Inc., approval mark). Unlike other forms of trademark, the owner of the certification mark (e.g., Good Housekeeping, or the Forest Stewardship Council’s FSC mark) is not the owner of the underlying product.

Extent of Trademark Protection

Kinds of Marks

Trademarks and other kinds of marks may consist of words and phrases, pictures, symbols, shapes, numerals, letters, slogans, and sounds. Trademarks are a part of our everyday world: the sounds of a radio or television network announcing itself (NBC, BBC), the unique shape of a soda bottle (Coca-Cola bottle), a series of initials (GE, KPMG, IBM), or an animal’s warning growl (MGM’s lion).

Limitations on Marks

Although trademarks abound, the law limits the subjects that may fall into one of the defined categories. Not every word or shape or symbol will be protected in an infringement action. To qualify for protection, a trademark must be used to identify and distinguish. The courts employ a four-part test: (1) Is the mark so arbitrary and fanciful that it merits the widest protection? (2) Is it “suggestive” enough to warrant protection without proof of secondary meaning? (3) Is it “descriptive,” warranting protection if secondary meaning is proved? (4) Is the mark generic and thus unprotectable?

These tests do not have mechanical answers; they call for judgment. Some marks are wholly fanciful, clearly identify origin of goods, and distinguish them from others—Kodak, for example. Other marks may not be so arbitrary but may nevertheless be distinctive, either when adopted or as a result of advertising—for example, Crest, as the name of a toothpaste.

Marks that are merely descriptive of the product are entitled to protection only if it can be shown that the mark has acquired secondary meaning. This term reflects a process of identification on the mark in the public mind with the originator of the product. Holiday Inn was initially deemed too descriptive: an inn where people might go on holiday. But over time, travelers came to identify the source of the Great Sign and the name Holiday Inn as the Holiday Inn Corporation in Memphis, and secondary meaning was granted. Holiday Inn could thus protect its mark against other innkeepers, hoteliers, and such; however, the trademark protection for the words Holiday Inn was limited to the corporation’s hotel and motel business, and no other.

Certain words and phrases may not qualify at all for trademark protection. These include generic terms like “straw broom” (for a broom made of straw) and ordinary words like “fast food.” In one case, a federal appeals court held that the word “Lite” is generic and cannot be protected by a beer manufacturer to describe a low-calorie brew. (*Miller Brewing Co. v. Falstaff Brewing Corp.*, 655

F.2d 5 (1st Cir. 1981).) Donald Trump's effort to trademark "You're fired!" and Paris Hilton's desire to trademark "That's hot!" were also dismissed as being generic.

Deceptive words will not be accepted for registration. Thus the US Patent and Trademark Office (PTO) denied registration to the word *Vynahyde* because it suggested that the plastic material to which it was applied came from animal skin. Geographic terms are descriptive words and may not be used as protected trademarks unless they have acquired a secondary meaning, such as Hershey when used for chocolates. (Hershey's chocolates are made in Hershey, Pennsylvania.) A design that reflects a common style cannot be protected in a trademark to exclude other similar designs in the same tradition. Thus the courts have ruled that a silverware pattern that is a "functional feature" of the "baroque style" does not qualify for trademark protection. Finally, the Lanham Act denies federal registration to certain marks that fall within categories of words and shapes, including the following: the flag; the name, portrait, or signature of any living person without consent, or of a deceased US president during the lifetime of his widow; and immoral, deceptive, or scandalous matter (in an earlier era, the phrase "Bubby Trap" for brassieres was denied registration).

Dilution, Tarnishment, and Blurring

Under the federal Trademark Dilution Act of 1995, companies with marks that dilute the value of a senior mark may be liable for damages. The act provides that owners of marks of significant value have property rights that should not be eroded, blurred, tarnished, or diluted in any way by another. But as a plaintiff, the holder of the mark must show (1) that it is a famous mark, (2) that the use of a similar mark is commercial, and (3) that such use causes dilution of the distinctive quality of the mark. Thus a T-shirt maker who promotes a red-and-white shirt bearing the mark Buttweiser may be liable to Anheuser-Busch, or a pornographic site called Candyland could be liable to Parker Brothers, the board game company. Interesting cases have already been brought under this act, including a case brought by Victoria's Secret against a small adult store in Kentucky called Victor's Little Secret. Notice that unlike most prior trademark law, the purpose is not to protect the consumer from confusion as to the source or origin of the goods or services being sold; for example, no one going to the Candyland site would think that Parker Brothers was the source.

Acquiring Trademark Rights

For the first time in more than forty years, Congress, in 1988, changed the way in which trademarks can be secured. Under the Lanham Act, the fundamental means of obtaining a trademark was through use. The manufacturer or distributor actually must have placed the mark on its product—or on related displays, labels, shipping containers, advertisements, and the like—and then have begun selling the product. If the product was sold in interstate commerce, the trademark was entitled to protection under the Lanham Act (or if not, to protection under the common law of the state in which the product was sold).

Under the Trademark Law Revision Act of 1988, which went into effect in 1989, trademarks can be obtained in advance by registering with the PTO an intention to use the mark within six months (the applicant can gain extensions of up to thirty more months to put the mark into use). Once obtained, the trademark will be protected for ten years (before the 1988 revision, a federal trademark remained valid for twenty years); if after that time the mark is still being used, the registration can be renewed. Obtaining a trademark registration lies between obtaining patents and obtaining copyrights in difficulty. The PTO will not routinely register a trademark; it searches its records to ensure that the mark meets several statutory tests and does not infringe another mark. Those who feel that their own marks would be hurt by registration of a proposed mark may file an opposition proceeding with the PTO.

In many foreign countries, use need not be shown to obtain trademark registration. It is common for some people in these countries to register marks that they expect to be valuable so that they can sell the right to use the mark to the company that established the mark's value. Companies that expect to market abroad should register their marks early.

Loss of Rights

Trademark owners may lose their rights if they abandon the mark, if a patent or copyright expires on which the mark is based, or if the mark becomes generic. A mark is abandoned if a company goes out of business and ceases selling the product. Some marks are based on design patents; when the patent expires, the patent holder will not be allowed to extend the patent's duration by arguing that the design or name linked with the design is a registrable trademark.

The most widespread difficulty that a trademark holder faces is the prospect of too much success: if a trademark comes to stand generically for the product itself, it may lose exclusivity in the mark. Famous examples are aspirin, escalator, and cellophane. The

threat is a continual one. Trademark holders can protect themselves from their marks' becoming generic in several ways.

1. Use a descriptive term along with the trademark. Look on a jar of Vaseline and you will see that the label refers to the contents as Vaseline petroleum jelly.
2. Protest generic use of the mark in all publications by writing letters and taking out advertisements.
3. Always put the words Trademark, Registered Trademark, or the symbol ® (meaning "registered") next to the mark itself, which should be capitalized.

Key Takeaway

Trademark protection is federal, under the Lanham Act. Branding of corporate logos, names, and products is essential to business success, and understanding trademarks is pivotal to branding. A "mark" must be distinctive, arbitrary, or fanciful to merit protection: this means that it must not be generic or descriptive. Marks can be words, symbols, pictures, slogans, sounds, phrases, and even shapes. In the United States, rights to marks are obtained by registration and intent to use in commerce and must be renewed every ten years.

Exercises

1. How will Google protect its trademark, assuming that people begin using "google" as a verb substitute for "Internet search," just like people began using the word "cellophane" for all brands of plastic wrap?
2. Do a small amount of web searching and find out what "trade dress" protection is, and how it differs from trademark protection.
3. LexisNexis is a brand for a database collection offered by Mead Data Central. Lexus is a high-end automobile. Can Lexus succeed in getting Mead Data Central to stop using "Lexis" as a mark?

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17.6: Summary and Exercises

Summary

The products of the human mind are at the root of all business, but they are legally protectable only to a certain degree. Inventions that are truly novel may qualify for a twenty-year patent; the inventor may then prohibit anyone from using the art (machine, process, manufacture, and the like) or license it on his own terms. A business may sue a person who improperly gives away its legitimate trade secrets, but it may not prevent others from using the unpatented trade secret once publicly disclosed. Writers or painters, sculptors, composers, and other creative artists may generally protect the expression of their ideas for the duration of their lives plus seventy years, as long as the ideas are fixed in some tangible medium. That means that they may prevent others from copying their words (or painting, etc.), but they may not prevent anyone from talking about or using their ideas. Finally, one who markets a product or service may protect its trademark or service or other mark that is distinctive or has taken on a secondary meaning, but may lose it if the mark becomes the generic term for the goods or services.

Exercises

1. Samuel Morse filed claims in the US Patent Office for his invention of the telegraph and also for the "use of the motive power of the electric or galvanic current…however developed, for marking or printing intelligible characters, signs or letters at any distances." For which claim, if any, was he entitled to a patent? Why?
2. In 1957, an inventor dreamed up and constructed a certain new kind of computer. He kept his invention a secret. Two years later, another inventor who conceived the same machine filed a patent application. The first inventor, learning of the patent application, filed for his own patent in 1963. Who is entitled to the patent, assuming that the invention was truly novel and not obvious? Why?
3. A large company discovered that a small company was infringing one of its patents. It wrote the small company and asked it to stop. The small company denied that it was infringing. Because of personnel changes in the large company, the correspondence file was lost and only rediscovered eight years later. The large company sued. What would be the result? Why?
4. Clifford Witter was a dance instructor at the Arthur Murray Dance Studios in Cleveland. As a condition of employment, he signed a contract not to work for a competitor. Subsequently, he was hired by the Fred Astaire Dancing Studios, where he taught the method that he had learned at Arthur Murray. Arthur Murray sued to enforce the noncompete contract. What would be result? What additional information, if any, would you need to know to decide the case?
5. Greenberg worked for Buckingham Wax as its chief chemist, developing chemical formulas for products by testing other companies' formulas and modifying them. Brite Products bought Buckingham's goods and resold them under its own name. Greenberg went to work for Brite, where he helped Brite make chemicals substantially similar to the ones it had been buying from Buckingham. Greenberg had never made any written or oral commitment to Buckingham restricting his use of the chemical formulas he developed. May Buckingham stop Greenberg from working for Brite? May it stop him from working on formulas learned while working at Buckingham? Why?

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CHAPTER OVERVIEW

18: The Transfer of Real Estate By Sale

Learning Objectives

After reading this chapter, you should understand the following:

- The various forms of real estate ownership, including fee simple, tenancy in common, and joint tenancy
- The mechanics of finding, financing, and closing a real estate transaction
- How adverse possession may sometimes vest title in real property despite the nonconsent of the owner

18.1: Introduction to the Transfer of Real Estate by Sale

18.2: Forms of Ownership

18.3: Brokers, Contracts, Proof of Title, and Closing

18.4: Adverse Possession

18.5: Summary and Exercises

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18.1: Introduction to the Transfer of Real Estate by Sale

This chapter follows the steps taken when real estate is transferred by sale.

1. The buyer selects a form of ownership.
2. The buyer searches for the real estate to be purchased. In doing so, the buyer will usually deal with real estate brokers.
3. After a parcel is selected, the seller and buyer will negotiate and sign a sales agreement.
4. The seller will normally be required to provide proof of title.
5. The buyer will acquire property insurance.
6. The buyer will arrange financing.
7. The sale and purchase will be completed at a closing.

During this process, the buyer and seller enter into a series of contracts with each other and with third parties such as brokers, lenders, and insurance companies. In this chapter, we focus on the unique features of these contracts, with the exception of mortgages and property insurance. We conclude by briefly examining adverse possession—a method of acquiring property for free.

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18.2: Forms of Ownership

Learning Objectives

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

- Be familiar with the various kinds of interest in real property.
- Know the ways that two or more people can own property together.
- Understand the effect of marriage, divorce, and death on various forms of property ownership.

One form of ownership of real property is legally quite simple, although lawyers refer to it with a complicated-sounding name. This is ownership by one individual, known as ownership in severalty. In purchasing real estate, however, buyers frequently complicate matters by grouping together—because of marriage, close friendship, or simply in order to finance the purchase more easily

When purchasers group together for investment purposes, they often use the various forms of organization—corporations, partnerships, limited partnerships, joint ventures, and business trusts. The most popular of these forms of organization for owning real estate is the limited partnership. A real estate limited partnership is designed to allow investors to take substantial deductions that offset current income from the partnership and other similar investments, while at the same time protecting the investor from personal liability if the venture fails.

But you do not have to form a limited partnership or other type of business in order to acquire property with others; many other forms are available for personal or investment purposes. To these we now turn.

Fee Simple Absolute

Fee simple absolute is the most complete form of ownership. The holder of a "fee simple" has complete ownership of land for all time. It can seel, transfer, lease, use, posses, or do anything else legally possible with the land.

Easement

An easement is a right to pass through or use the land of another. Examples include cities owning easements across homeowners' land for the purpsoes of having sidewalks throughout a community or a utility company having an easement to run service lines across numerous properties.

Joint Tenancy

Joint tenancy is an estate in land owned by two or more persons. It is distinguished chiefly by the right of survivorship. If two people own land as joint tenants, then either becomes the sole owner when the other dies. For land to be owned jointly, four unities must coexist:

1. Unity of time. The interests of the joint owners must begin at the same time.
2. Unity of title. The joint tenants must acquire their title in the same conveyance—that is, the same will or deed.
3. Unity of interest. Each owner must have the same interest in the property; for example, one may not hold a life estate and the other the remainder interest.
4. Unity of possession. All parties must have an equal right to possession of the property (see Figure 31.1).

Unities	Joint Tenancy	Tenancy by Entirety	Tenancy in Common
Time	✓	✓	
Title	✓	✓	
Interest	✓	✓	
Possession	✓	✓	✓
Person		✓	

Figure 31.1 Forms of Ownership and Unities

Suppose a woman owns some property and upon marriage wishes to own it jointly with her husband. She deeds it to herself and her husband “as joint tenants and not tenants in common.” Strictly speaking, the common law would deny that the resulting form of ownership was joint because the unities of title and time were missing. The wife owned the property first and originally acquired title under a different conveyance. But the modern view in most states is that an owner may convey directly to herself and another in order to create a joint estate.

When one or more of the unities is destroyed, however, the joint tenancy lapses. Fritz and Gary own a farm as joint tenants. Fritz decides to sell his interest to Jesse (or, because Fritz has gone bankrupt, the sheriff auctions off his interest at a foreclosure sale). Jesse and Gary would hold as tenants in common and not as joint tenants. Suppose Fritz had made out his will, leaving his interest in the farm to Reuben. On Fritz’s death, would the unities be destroyed, leaving Gary and Reuben as tenants in common? No, because Gary, as joint tenant, would own the entire farm on Fritz’s death, leaving nothing behind for Reuben to inherit.

Tenancy by the Entirety

About half the states permit husbands and wives to hold property as tenants by the entirety. This form of ownership is similar to joint tenancy, except that it is restricted to husbands and wives. This is sometimes described as the unity of person. In most of the states permitting tenancy by the entirety, acquisition by husband and wife of property as joint tenants automatically becomes a tenancy by the entirety. The fundamental importance of tenancy by the entirety is that neither spouse individually can terminate it; only a joint decision to do so will be effective. One spouse alone cannot sell or lease an interest in such property without consent of the other, and in many states a creditor of one spouse cannot seize the individual’s separate interest in the property, because the interest is indivisible.

Tenancy in Common

Two or more people can hold property as tenants in common when the unity of possession is present, that is, when each is entitled to occupy the property. None of the other unities—of time, title, or interest—is necessary, though their existence does not impair the common ownership. Note that the tenants in common do not own a specific portion of the real estate; each has an undivided share in the whole, and each is entitled to occupy the whole estate. One tenant in common may sell, lease, or mortgage his undivided interest. When a tenant in common dies, his interest in the property passes to his heirs, not to the surviving tenants in common.

Because tenancy in common does not require a unity of interest, it has become a popular form of “mingling,” by which unrelated people pool their resources to purchase a home. If they were joint tenants, each would be entitled to an equal share in the home, regardless of how much each contributed, and the survivor would become sole owner when the other owner dies. But with a tenancy-in-common arrangement, each can own a share in proportion to the amount invested.

Community Property

In ten states—Alaska, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin—property acquired during a marriage is said to be community property. There are differences among these states, but the general theory is that with certain exceptions, each spouse has an undivided equal interest in property acquired while the husband and wife are married to each other. The major exception is for property acquired by gift or inheritance during the marriage. (By definition, property owned by either spouse before the marriage is not community property.) Property acquired by gift of inheritance or owned before the marriage is known as separate property. Community property states recognize other forms of ownership; specifically, husbands and wives may hold property as joint tenants, permitting the survivor to own the whole.

The consequence of community property laws is that either the husband or the wife may manage the community property, borrow against it, and dispose of community personal property. Community real estate may only be sold or encumbered by both jointly. Each spouse may bequeath only half the community property in his or her will. In the absence of a will, the one-half property interest will pass in accordance with the laws of intestate succession. If the couple divorces, the states generally provide for an equal or near-equal division of the community property, although a few permit the court in its discretion to divide in a different proportion.

Condominiums

In popular discussions, a condominium is seen as a kind of apartment building, but that is not its technical legal meaning. Condominium is a form of ownership, not a form of structure, and it can even apply to space—for example, to parking spaces in a garage. The word *condominium* means joint ownership or control, and it has long been used whenever land has been particularly scarce or expensive. Condominiums were popular in ancient Rome (especially near the Forum) and in the walled cities of medieval Europe.

In its modern usage, *condominium* refers to a form of housing involving two elements of ownership. The first is the living space itself, which may be held in common, in joint tenancy, or in any other form of ownership. The second is the common space in the building, including the roof, land under the structure, hallways, swimming pool, and the like. The common space is held by all purchasers as tenants in common. The living space may not be sold apart from the interest in the common space.

Two documents are necessary in a condominium sale—the master deed and the bylaws. The master deed (1) describes the condominium units, the common areas, and any restrictions that apply to them; (2) establishes the unit owner's interest in the common area, his number of votes at owners' association meetings, and his share of maintenance and operating expenses (sometimes unit owners have equal shares, and sometimes their share is determined by computing the ratio of living area or market price or original price of a single unit to the whole); and (3) creates a board of directors to administer the affairs of the whole condominium. The bylaws usually establish the owners' association, set out voting procedures, list the powers and duties of the officers, and state the obligations of the owners for the use of the units and the common areas.

Cooperatives

Another popular form of owning living quarters with common areas is the cooperative. Unlike the person who lives in a condominium, the tenant of a cooperative does not own a particular unit. Instead, he owns a share of the entire building. Since the building is usually owned by a corporation (a cooperative corporation, hence the name), this means that the tenant owns stock in the corporation. A tenant occupies a unit under a lease from the corporation. Together, the lease and stock in the building corporation are considered personal, not real, property.

In a condominium, an owner of a unit who defaults in paying monthly mortgage bills can face foreclosure on the unit, but neighbors in the building suffer no direct financial impact, except that the defaulter probably has not paid monthly maintenance charges either. In a cooperative, however, a tenant who fails to pay monthly charges can jeopardize the entire building, because the mortgage is on the building as a whole; consequently, the others will be required to make good the payments or face foreclosure.

Time-Shares

A time-share is an arrangement by which several people can own the same property while being entitled to occupy the premises exclusively at different times on a recurring basis. In the typical vacation property, each owner has the exclusive right to use the apartment unit or cottage for a specified period of time each year—for example, Mr. and Mrs. Smith may have possession from December 15 through December 22, Mr. and Mrs. Jones from December 23 through December 30, and so on. The property is usually owned as a condominium but need not be. The sharers may own the property in fee simple, hold a joint lease, or even belong to a vacation club that sells time in the unit.

Time-share resorts have become popular in recent years. But the lure of big money has brought unscrupulous contractors and salespersons into the market. Sales practices can be unusually coercive, and as a result, most states have sets of laws specifically to regulate time-share sales. Almost all states provide a cooling-off period, or rescission period; these periods vary from state to state and provide a window where buyers can change their minds without forfeiting payments or deposits already made.

Key Takeaway

Property is sometimes owned by one person or one entity, but more often two or more persons will share in the ownership. Various forms of joint ownership are possible, including joint tenancies, tenancy by the entirety, and tenancy in common. Married persons should be aware of whether the state they live in is a community property state; if it is, the spouse will take some interest in any property acquired during the marriage. Beyond traditional landholdings, modern real estate ownership may include interests in condominiums, cooperatives, or time-shares.

Exercises

1. Miguel and Maria Ramirez own property in Albuquerque, New Mexico, as tenants by the entirety. Miguel is a named defendant in a lawsuit that alleges defamation, and an award is made for $245,000 against Miguel. The property he owns with Maria is worth $320,000 and is owned free of any mortgage interest. To what extent can the successful plaintiff recover damages by forcing a sale of the property?
2. Miguel and Maria Ramirez own property in Albuquerque, New Mexico, as tenants by the entirety. They divorce. At the time of the divorce, there are no new deeds signed or recorded. Are they now tenants in common or joint tenants?

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18.3: Brokers, Contracts, Proof of Title, and Closing

Learning Objectives

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

- Know the duties of the real estate broker and how brokers are licensed.
- Be able to discuss the impact of constitutonal and statutory law on real estate sellers and brokers.
- Describe the various kinds of listing contracts and their import.
- Know the elements of a sales agreement and the various types of deeds to real estate.
- Understand the closing process and how “good title” is obtained through the title search and insurance process.

Once the buyer (or buyers) knows what form of ownership is most desirable, the search for a suitable property can begin. This search often involves contact with a broker hired by the seller. The seller’s contract with the broker, known as the listing agreement, is the first of the series of contracts in a typical real estate transaction. As you consider these contracts, it is important to keep in mind that despite the size of the transaction and the dire financial consequences should anything go awry, the typical person (buyer or seller) usually acts as his or her own attorney. An American Bar Association committee has noted the following:

It is probably safe to say that in a high percentage of cases the seller is unrepresented and signs the contracts of brokerage and sale on the basis of his faith in the broker. The buyer does not employ a lawyer. He signs the contract of sale without reading it and, once financing has been obtained, leaves all the details of title search and closing to the lender or broker. The lender or broker may employ an attorney but, where title insurance is furnished by a company maintaining its own title plant, it is possible that no lawyer, not even house counsel, will appear.

This being so, the material that follows is especially important for buyers and sellers who are not represented in the process of buying or selling real estate.

Regulation of the Real Estate Business

State Licensing

Real estate brokers, and the search for real estate generally, are subject to state and federal government regulation. Every state requires real estate brokers to be licensed. To obtain a license, the broker must pass an examination covering the principles of real estate practice, transactions, and instruments. Many states additionally insist that the broker take several courses in finance, appraisal, law, and real estate practice and apprentice for two years as a salesperson in a real estate broker’s office.

Civil Rights Act

Two federal civil rights laws also play an important role in the modern real estate transaction. These are the Civil Rights Act of 1866 and the Civil Rights Act of 1968 (Fair Housing Act). In *Jones v. Alfred H. Mayer Co.*, 392 U.S. 409 (1968). the Supreme Court upheld the constitutionality of the 1866 law, which expressly gives all citizens of the United States the same rights to inherit, purchase, lease, sell, hold, and convey real and personal property. A minority buyer or renter who is discriminated against may sue for relief in federal court, which may award damages, stop the sale of the house, or even direct the seller to convey the property to the plaintiff.

The 1968 Fair Housing Act prohibits discrimination on the grounds of race, color, religion, sex, national origin, handicap, or family status (i.e., no discrimination against families with children) by any one of several means, including the following:

1. Refusing to sell or rent to or negotiate with any person
2. Discriminating in the terms of sale or renting
3. Discriminating in advertising
4. Denying that the housing is available when in fact it is
5. “Blockbusting” (panicking owners into selling or renting by telling them that minority groups are moving into the neighborhood)
6. Creating different terms for granting or denying home loans by commercial lenders

7. Denying anyone the use of real estate services

Hiring the Broker: The Listing Agreement

When the seller hires a real estate broker, he will sign a listing agreement. (In several states, the Statute of Frauds says that the seller must sign a written agreement; however, he should do so in all states in order to provide evidence in the event of a later dispute.) This listing agreement sets forth the broker's commission, her duties, the length of time she will serve as broker, and other terms of her agency relationship. Whether the seller will owe a commission if he or someone other than the broker finds a buyer depends on which of three types of listing agreements has been signed.

Exclusive Right to Sell

If the seller agrees to an exclusive-right-to-sell agency, she will owe the broker the stated commission regardless of who finds the buyer. Language such as the following gives the broker an exclusive right to sell: "Should the seller or anyone acting for the seller (including his heirs) sell, lease, transfer, or otherwise dispose of the property within the time fixed for the continuance of the agency, the broker shall be entitled nevertheless to the commission as set out herein."

Exclusive Agency

Somewhat less onerous from the seller's perspective (and less generous from the broker's perspective) is the exclusive agency. The broker has the exclusive right to sell and will be entitled to the commission if anyone other than the seller finds the buyer (i.e., the seller will owe no commission if he finds a buyer). Here is language that creates an exclusive agency: "A commission is to be paid the broker whether the purchaser is secured by the broker or by any person other than the seller."

Open Listing

The third type of listing, relatively rarely used, is the open listing, which authorizes "the broker to act as agent in securing a purchaser for my property." The open listing calls for payment to the broker only if the broker was instrumental in finding the buyer; the broker is not entitled to her commission if anyone else, seller or otherwise, locates the buyer.

Suppose the broker finds a buyer, but the seller refuses at that point to sell. May the seller simply change his mind and avoid having to pay the broker's commission? The usual rule is that when a broker finds a buyer who is "ready, willing, and able" to purchase or lease the property, she has earned her commission. Many courts have interpreted this to mean that even if the buyers are unable to obtain financing, the commission is owed nevertheless once the prospective buyers have signed a purchase agreement. To avoid this result, the seller should insist on either a "no deal, no commission" clause in the listing agreement (entitling the broker to payment only if the sale is actually consummated) or a clause in the purchase agreement making the purchase itself contingent on the buyer's finding financing.

Broker's Duties

Once the listing agreement has been signed, the broker becomes the seller's agent—or, as occasionally happens, the buyer's agent, if hired by the buyer. A broker is not a general agent with broad authority. Rather, a broker is a special agent with authority only to show the property to potential buyers. Unless expressly authorized, a broker may not accept money on behalf of the seller from a prospective buyer. Suppose Eunice hires Pete's Realty to sell her house. They sign a standard exclusive agency listing, and Pete cajoles Frank into buying the house. Frank writes out a check for $10,000 as a down payment and offers it to Pete, who absconds with the money. Who must bear the loss? Ordinarily, Frank would have to bear the loss, because Pete was given no authority to accept money. If the listing agreement explicitly said that Pete could accept the down payment from a buyer, then the loss would fall on Eunice.

Although the broker is but a special agent, she owes the seller, her principal, a fiduciary duty. (See Chapter 14 on relations between principal and agent.) A fiduciary duty is a duty of the highest loyalty and trust. It means that the broker cannot buy the property for herself through an intermediary without full disclosure to the seller of her intentions. Nor may the broker secretly receive a commission from the buyer or suggest to a prospective buyer that the property can be purchased for less than the asking price.

The Sales Agreement

Once the buyer has selected the real estate to be acquired, an agreement of sale will be negotiated and signed. Our discussion here will focus on specific aspects of the real estate contract. The Statute of Frauds requires that contracts for sale of real estate must be in writing. The writing must contain certain information.

Names of Buyers and Sellers

The agreement must contain the names of the buyers and sellers. As long as the parties sign the agreement, however, it is not necessary for the names of buyers and sellers to be included within the body of the agreement.

Real Estate Description

The property must be described sufficiently for a court to identify the property without having to look for evidence outside the agreement. The proper address, including street, city, and state, is usually sufficient.

Price

The price terms must be clear enough for a court to enforce. A specific cash price is always clear enough. But a problem can arise when installment payments are to be made. To say "$50,000, payable monthly for fifteen years at 12 percent" is not sufficiently detailed, because it is impossible to determine whether the installments are to be equal each month or are to be equal principal payments with varying interest payments, declining monthly as the balance decreases.

Signature

As a matter of prudence, both buyer and seller should sign the purchase agreement. However, the Statute of Frauds requires only the signature of the party against whom the agreement is to be enforced. So if the seller has signed the agreement, he cannot avoid the agreement on the grounds that the buyer has not signed it. However, if the buyer, not having signed, refuses to go to closing and take title, the seller would be unable to enforce the agreement against him.

Easements and Restrictive Covenants

Unless the contract specifically states otherwise, the seller must deliver marketable title. A marketable title is one that is clear of restrictions to which a reasonable buyer would object. Most buyers would refuse to close the deal if there were potential third-party claims to all or part of the title. But a buyer would be unreasonable if, at closing, he refused to consummate the transaction on the basis that there were utility easements for the power company or a known and visible driveway easement that served the neighboring property. As a precaution, a seller must be sure to say in the contract for sale that the property is being sold "subject to easements and restrictions of record." A buyer who sees only such language should insist that the particular easements and restrictive covenants be spelled out in the agreement before he signs.

Risk of Loss

Suppose the house burns down after the contract is signed but before the closing. Who bears the loss? Once the contract is signed, most states apply the rule of equitable conversion, under which the buyer's interest (his executory right to enforce the contract to take title to the property) is regarded as real property, and the seller's interest is regarded as personal property. The rule of equitable conversion stems from an old maxim of the equity courts: "That which ought to be done is regarded as done." That is, the buyer ought to have the property and the seller ought to have the money. A practical consequence of this rule is that the loss of the property falls on the buyer. Because most buyers do not purchase insurance until they take title, eleven states have adopted the Uniform Vendor and Purchaser Risk Act, which reverses the equitable conversion rule and places risk of loss on the seller. The parties may themselves reverse the application of the rule; the buyer should always insist on a clause in a contract stating that risk of loss remains with the seller until a specified date, such as the closing.

Earnest Money

As protection against the buyer's default, the seller usually insists on a down payment known as earnest money. This is intended to cover such immediate expenses as proof of marketable title and the broker's commission. If the buyer defaults, he forfeits the earnest money, even if the contract does not explicitly say so.

Contingencies

Performance of most real estate contracts is subject to various contingencies—that is, it is conditioned on the happening of certain events. For example, the buyer might wish to condition his agreement to buy the house on his ability to find a mortgage or to find one at a certain rate of interest. Thus the contract for sale might read that the buyer "agrees to buy the premises for $50,000, subject to his obtaining a $40,000 mortgage at 5 percent." The person protected by the contingency may waive it; if the lowest interest rate the buyer could find was 5.5 percent, he could either refuse to buy the house or waive the condition and buy it anyway.

Times for Performance

A frequent difficulty in contracting to purchase real estate is the length of time it takes to receive an acceptance to an offer. If the acceptance is not received in a reasonable time, the offeror may treat the offer as rejected. To avoid the uncertainty, an offeror should always state in his offer that it will be held open for a definite period of time (five working days, two weeks, or whatever). The contract also ought to spell out the times by which the following should be done: (1) seller's proof that he has title, (2) buyer's review of the evidence of title, (3) seller's correction of title defects, (4) closing date, and (5) possession by the buyer. The absence of explicit time provisions will not render the contract unenforceable—the courts will infer a reasonable time—but their absence creates the possibility of unnecessary disputes.

Types of Deeds

Most real estate transactions involve two kinds of deeds, the general warranty deed and the quitclaim deed.

1. **General warranty deed.** In a warranty deed, the seller warrants to the buyer that he possesses certain types of legal rights in the property. In the general warranty deed, the seller warrants that (a) he has good title to convey, (b) the property is free from any encumbrance not stated in the deed (the warranty against encumbrances), and (c) the property will not be taken by someone with a better title (the warranty of quiet enjoyment). Breach of any of these warranties exposes the seller to damages.
2. **Quitclaim deed.** The simplest form of deed is the quitclaim deed, in which the seller makes no warranties. Instead, he simply transfers to the buyer whatever title he had, defects and all. A quitclaim deed should not be used in the ordinary purchase and sale transaction. It is usually reserved for removing a cloud on the title—for instance, a quitclaim deed by a widow who might have a dower interest in the property.If the purchase agreement is silent about the type of deed, courts in many states will require the seller to give the buyer a quitclaim deed. In the contract, the buyer should therefore specify that the seller is to provide a warranty deed at closing.

When buyers move in after the closing, they frequently discover defects (the boiler is broken, a pipe leaks, the electrical power is inadequate). To obtain recourse against such an eventuality, the buyer could attempt to negotiate a clause in the contract under which the seller gives a warranty covering named defects. However, even without an express warranty, the law implies two warranties when a buyer purchases a new house from a builder. These are warranties that (1) the house is habitable and (2) the builder has completed the house in a workmanlike manner. Most states have refused to extend these warranties to subsequent purchasers—for example, to the buyer from a seller who had bought from the original builder. However, a few states have begun to provide limited protection to subsequent purchasers—in particular, for defects that a reasonable inspection will not reveal but that will show up only after purchase.

Proof of Title

Contracts are often formed and performed simultaneously, but in real estate transactions there is more often a gap between contract formation and performance (the closing). The reason is simple: the buyer must have time to obtain financing and to determine whether the seller has marketable title. That is not always easy; at least, it is not as straightforward as looking at a piece of paper. To understand how title relates to the real estate transaction, some background on recording statutes will be useful.

Recording Statutes

Suppose Slippery Sam owned Whispering Pines, a choice resort hotel on Torch Lake. On October 1, Slippery deeded Whispering Pines to Lorna for $1,575,000. Realizing the profit potential, Slippery decided to sell it again, and did so on November 1, without bothering to tell Malvina, the new buyer to whom he gave a new deed, that he had already sold it to Lorna. He then departed for a long sailing trip to the British Virgin Islands.

When Malvina arrives on the doorstep to find Lorna already tidying up, who should prevail? At common law, the first deed prevailed over subsequent deeds. So in our simple example, if this were a pure common-law state, Lorna would have title and Malvina would be out of luck, stuck with a worthless piece of paper. Her only recourse, probably futil

Chain of Title

Given the recording statutes, the buyer must check the deed on record to determine (1) whether the seller ever acquired a valid deed to the property—that is, whether a chain of title can be traced from earlier owners to the seller—and (2) whether the seller has already sold the property to another purchaser, who has recorded a deed. There are any number of potential "clouds" on the title that would defeat a fee simple conveyance: among others, there are potential judgments, liens, mortgages, and easements that might affect the value of the property. There are two ways to protect the buyer: the abstract of title and opinion, and title insurance.

Abstract and Opinion

An abstract of title is a summary of the chain of title, listing all previous deeds, mortgages, tax liens, and other instruments recorded in the county land records office. The abstract is prepared by either an attorney or a title company. Since the list itself says nothing about whether the recorded instruments are legally valid, the buyer must also have the opinion of an attorney reviewing the abstract, or must determine by doing his own search of the public records, that the seller has valid title. The attorney's opinion is known as a title opinion or certificate of title. The problem with this method of proving title is that the public records do not reveal hidden defects. One of the previous owners might have been a minor or an incompetent person who can still void his sale, or a previous deed might have been forged, or a previous seller might have claimed to be single when in fact he was married and his wife failed to sign away her dower rights. A search of the records would not detect these infirmities.

Title Insurance

To overcome these difficulties, the buyer should obtain title insurance. This is a one-premium policy issued by a title insurance company after a search through the same public records. When the title company is satisfied that title is valid, it will issue the insurance policy for a premium that could be as high as 1 percent of the selling price. When the buyer is taking out a mortgage, he will ordinarily purchase two policies, one to cover his investment in the property and the other to cover the mortgagee lender's loan. In general, a title policy protects the buyer against losses that would occur if title (1) turns out to belong to someone else; (2) is subject to a lien, encumbrance, or other defect; or (3) does not give the owner access to the land. A preferred type of title policy will also insure the buyer against losses resulting from an unmarketable title.

Note that in determining whether to issue a policy, the title company goes through the process of searching through the public records again. The title policy as such does not guarantee that title is sound. A buyer could conceivably lose part or all of the property someday to a previous rightful owner, but if he does, the title insurance company must reimburse him for his losses.

Although title insurance is usually a sound protection, most policies are subject to various exclusions and exceptions. For example, they do not provide coverage for zoning laws that restrict use of the property or for a government's taking of the property under its power of eminent domain. Nor do the policies insure against defects created by the insured or known by the insured but unknown to the company. Some companies will not provide coverage for mechanics' liens, public utility easements, and unpaid taxes. (If the accrued taxes are known, the insured will be presented with a list, and if he pays them on or before the closing, they will be covered by the final policy.) Furthermore, as demonstrated in *Title and Trust Co. of Florida v. Barrows*, (see Section 31.4.1 "Title Insurance"), title insurance covers title defects only, not physical defects in the property.

The Closing

Closing can be a confusing process because in most instances several contracts are being performed simultaneously:

1. The seller and purchaser are performing the sales contract.
2. The seller is paying off a mortgage, while the buyer is completing arrangements to borrow money and mortgage the property.
3. Title and other insurance arrangements will be completed.
4. The seller will pay the broker.
5. If buyer and seller are represented, attorneys for each party will be paid.

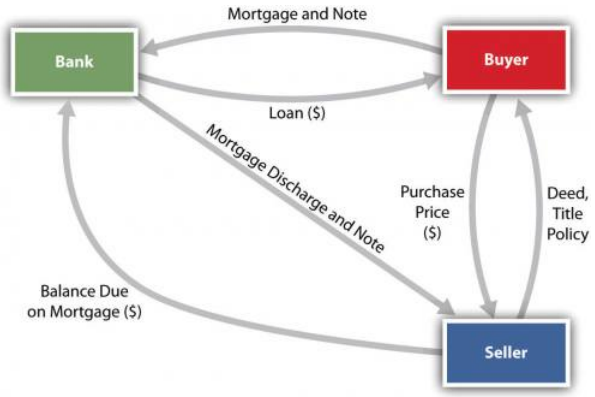


Figure 31.2 Closing Process

Despite all these transactions, the critical players are the seller, the purchaser, and the bank. To place the closing process in perspective, assume that one bank holds the existing (seller's) mortgage on the property and is also financing the buyer's purchase. We can visualize the three main players sitting at a table, ready to close the transaction. The key documents and the money will flow as illustrated in Figure 31.2.

Form of the Deed

The deed must satisfy two fundamental legal requirements: it must be in the proper form, and there must be a valid delivery. Deeds are usually prepared by attorneys, who must include not only information necessary for a valid deed but also information required in order to be able to record the deed. The following information is typically required either for a valid deed or by the recording statutes.

Grantor

The grantor—the person who is conveying the property—must be designated in some manner. Obviously, it is best to give the grantor's full name, but it is sufficient that the person or persons conveying the deed are identifiable from the document. Thus "the heirs of Lockewood Filmer" is sufficient identification if each of the heirs signs the deed.

Grantee

Similarly, the deed should identify the grantee—the person to whom the property is being conveyed. It does not void the deed to misspell a person's name or to omit part of a name, or even to omit the name of one of the grantees (as in "Lockewood Filmer and wife"). Although not technically necessary, the deed ought to detail the interests being conveyed to each grantee in order to avoid considerable legal difficulty later. "To Francis Lucas, a single man, and Joseph Lucas and Matilda Lucas, his wife" was a deed of unusual ambiguity. Did each party have a one-third interest? Or did Joseph and Matilda hold half as tenants by the entirety and Francis have a one-half interest as a tenant in common? Or perhaps Francis had a one-third interest as a tenant in common and Joseph and Matilda held two-thirds as tenants by the entirety? Or was there some other possible combination? The court chose the second interpretation, but considerable time and money could have been saved had the deed contained a few simple words of explanation.*Heatter v. Lucas*, 80 A.2d 749 (Pa. 1951).

Addresses

Addresses of the parties should be included, although their absence will not usually invalidate the deed. However, in some states, failure to note the addresses will bar the deed from being recorded.

Words of Conveyance

The deed must indicate that the grantor presently intends to convey his interest in the property to the grantee. The deed may recite that the grantor "conveys and warrants" the property (warranty deed) or "conveys and quitclaims" the property (quitclaim deed). Some deeds use the words "bargain and sell" in place of convey.

Description

The deed must contain an accurate description of the land being conveyed, a description clear enough that the land can be identified without resorting to other evidence. Four general methods are used.

1. **The US government survey.** This is available west of the Mississippi (except in Texas) and in Alabama, Florida, Illinois, Indiana, Michigan, Mississippi, Ohio, and Wisconsin. With this survey, it is possible to specify with considerable exactitude any particular plot of land in any township in these states.
2. **Metes and bounds.** The description of metes and bounds begins with a particular designated point (called a monument)—for example, a drainpipe, an old oak tree, a persimmon stump—and then defines the boundary with distances and angles until returning to the monument. As you can tell, using monuments that are biological (like trees and stumps) will have a limited utility as time goes on. Most surveyors put in stakes (iron pins), and the metes and bounds description will go from points where stakes have been put in the ground.
3. **Plats.** Many land areas have been divided into numbered lots and placed on a map called a plat. The plats are recorded. The deed, then, need only refer to the plat and lot number—for example, "Lot 17, Appledale Subdivision, record in Liber 2 of Plats, page 62, Choctaw County Records."
4. **Informal description.** If none of the preceding methods can be used, an informal description, done precisely enough, might suffice. For instance, "my home at 31 Fernwood Street, Maplewood, Idaho" would probably pass muster.

Statement of Consideration

Statutes usually require that some consideration be stated in the deed, even though a grantor may convey property as a gift. When there is a selling price, it is easy enough to state it, although the actual price need not be listed. When land is being transferred as a gift, a statement of nominal consideration—for example, one dollar—is sufficient.

Date

Dates are customary, but deeds without dates will be enforced.

Execution

The deed must be signed by the grantor and, in some states, witnesses, and these signatures must be acknowledged by a notary public in order to make the deed eligible for recording. If someone is signing for the grantor under a power of attorney, a written instrument authorizing one person to sign for another, the instrument must be recorded along with the deed.

Delivery

To validly convey title to the property, the deed must not only be in proper form but also be delivered. This technical legal requirement is sometimes misunderstood. Delivery entails (1) physical delivery to the grantee, (2) an intention by the grantor to convey title, and (3) acceptance of title by the grantee. Because the grantor must intend to convey title, failure to meet the other two elements during the grantor's lifetime will void title on his death (since at that point he of course cannot have an intention). Thus when a grantee is unaware of the grantor's intention to deed the property to him, an executed deed sitting in a safe-deposit box will be invalid if discovered after the grantor's death.

Delivery to Grantee

If the deed is physically delivered to the grantee or recorded, there is a rebuttable presumption that legal delivery has been made. That is, the law presumes, in the absence of evidence to the contrary, that all three conditions have been met if delivery or recording takes place. But this presumption can be rebutted, as shown in *Havens v. Schoen*, (see Section 31.4.2 "Delivery of a Deed").

Delivery to Third Party (Commercial Escrow)

The grantor may deliver the deed to a third party to hold until certain conditions have been met. Thus to avoid the problem of the deed sitting in the grantor's own safe-deposit box, he could deliver it to a third party with instructions to hold it until his death and then to deliver it to the grantee. This would be an effective delivery, even though the grantee could not use the property until the grantor died. For this method to be effective, the grantor must lose all control over the deed, and the third party must be instructed to deliver the deed when the specified conditions occur.

This method is most frequently used in the commercial escrow. Escrow is a method by which a third party holds a document or money or both until specified conditions have been met. A typical example would be a sale in which the buyer is afraid of liens that might be filed after the closing. A contractor that has supplied materials for the building of a house, for example, might file a lien against the property for any amounts due but unpaid under the contract. The effectiveness of the lien would relate back to the time that the materials were furnished. Thus, at closing, all potential liens might not have been filed. The buyer would prefer to pay the seller after the time for filing materialmen's liens has lapsed. But sellers ordinarily want to ensure that they will receive their money before delivering a deed. The solution is for the buyer to pay the money into escrow (e.g., to a bank) and for the seller to deliver the deed to the same escrow agent. The bank would be instructed to hold both the money and the deed until the time for filing mechanics' liens has ended. If no materialmen's liens have been filed, then the money is paid out of escrow to the seller and the deed is released to the buyer. If a lien has been filed, then the money will not be paid until the seller removes the lien (usually by paying it off).

Key Takeaway

Most real estate is bought and sold through real estate brokers, who must be licensed by the state. Brokers have different kinds of agreements with clients, including exclusive right to sell, exclusive agency, and open listing. Brokers will usually arrange a sales agreement that includes standard provisions such as property description, earnest money, and various contingencies. A deed, usually a warranty deed, will be exchanged at the closing, but not before the buyer has obtained good proof of title, usually by getting an abstract and opinion and paying for title insurance. The deed will typically be delivered to the buyer and recorded at the county courthouse in the register of deeds' office.

Exercises

1. Kitty Korniotis is a licensed real estate broker. Barney Woodard and his wife, Carol, sign an exclusive agency listing with Kitty to sell their house on Woodvale Avenue. At a social gathering, Carol mentions to a friend, Helen Nearing, that the house on Woodvale is for sale. The next day, Helen drives by the property and calls the number on Kitty's sign. Helen and Scott Nearing sign a contract to buy the house from the Woodards. Is Kitty entitled to the commission?
2. Deepak Abhishek, a single man, lives in a race-notice state. He contracts to buy a large parcel of land from his friend, Ron Khurana, for the sum of $280,000. Subsequent to the contract, Khurana finds another buyer, who is willing to pay $299,000. Khurana arranges for two closings on the same day, within two hours of each other. At 10 a.m., he sells the property to Beverly Hanks and her husband, John, for $299,000. The Hanks are not represented by an attorney. Khurana hands them the deed at closing, but he takes it back from them and says, "I will record this at the courthouse this afternoon." The Hankses take a copy of the deed with them and are satisfied that they have bought the property; moreover, Khurana gives them a commitment from Lawyer's Title Company that the company will insure that they are receiving fee simple title from Khurana, subject to the deed's being recorded in the county register of deeds' office.At noon, Khurana has a closing with Abhishek, who is represented by an attorney. The attorney went to the courthouse earlier, at 11:30 a.m., and saw nothing on record that would prevent Khurana from conveying fee simple title. As the deal closes, and as Khurana prepares to leave town, Abhishek's attorney goes to the courthouse and records the deed at 1:15 p.m. At 2:07 p.m., on his way out of town, Abhishek records the deed to the Hankses.
    1. Who has better claim to the property—the Hankses or Deepak Abhishek?
    2. Does it matter if the state is a notice jurisdiction or a notice-race jurisdiction?
    3. A warranty deed is given in both closings. What would be the best remedy for whichever buyer did not get the benefit of clear title from these two transactions?

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18.4: Adverse Possession

Learning Objectives

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

- Explain how it is possible to own land without paying for it.

In some instances, real property can be acquired for free—or at least without paying the original owner anything. (Considerable cost may be involved in meeting the requisite conditions.) This method of acquisition—known as **adverse possession**—is effective when five conditions are met: (1) the person claiming title by adverse possession must assert that he has a right to possession hostile to the interest of the original owner, (2) he must actually possess the property, (3) his possession must be "open and notorious," (4) the possession must be continuous, and (5) the possession must be exclusive.

Hostile Possession

Suppose Jean and Jacques are tenants in common of a farm. Jean announces that he no longer intends to pursue agricultural habits and leaves for the city. Jacques continues to work on the land, making improvements and paying taxes and the mortgage. Years later, Jacques files suit for title, claiming that he now owns the land outright by adverse possession. He would lose, since his possession was not hostile to Jacques. To be hostile, possession of the land must be without permission and with the intention to claim ownership. Possession by one cotenant is deemed permissive, since either or both are legally entitled to possession. Suppose, instead, that Jean and Jacques are neighboring farmers, each with title to his own acreage, and that Jean decides to fence in his property. Just to be on the safe side, he knowingly constructs the fence twenty feet over on Jacques's side. This is adverse possession, since it is clearly hostile to Jacques's possession of the land.

Actual Possession

Not only must the possession be hostile but it must also be actual. The possessor must enter onto the land and make some use of it. Many state statutes define the permissible type of possession—for example, substantial enclosure or cultivation and improvement. In other states, the courts will look to the circumstances of each case to determine whether the claimant had in fact possessed the land (e.g., by grazing cattle on the land each summer).

Open and Notorious Possession

The possessor must use the land in an open way, so that the original owner could determine by looking that his land was being claimed and so that people in the area would know that it was being used by the adverse possessor. In the melodramatic words of one court, the adverse possessor "must unfurl his flag on the land, and keep it flying so that the owner may see, if he will, that an enemy has invaded his domains, and planted the standard of conquest."*Robin v. Brown*, 162 A. 161 (Pa. 1932). Construction of a building on the owner's property would be open and notorious; development of a cave or tunnel under the owner's property would not be.

Continuous Possession

The adverse possessor must use the land continuously, not intermittently. In most states, this continuous period must last for at least twenty years. If the adverse possession is passed on to heirs or the interest is sold, the successor adverse possessors may tack on the time they claim possession to reach the twenty years. Should the original owner sell his land, the time needed to prove continuous possession will not lapse. Of course, the original owner may interrupt the period—indeed, may terminate it—by moving to eject the adverse possessor any time before the twenty years has elapsed.

Exclusive Possession

The adverse possessor must claim exclusive possession of the land. Sharing the land with the owner is insufficient to ground a claim of legal entitlement based on adverse possession, since the sharing is not fully adverse or hostile. Jean finds a nice wooded lot to enjoy weekly picnics. The lot belongs to Jacques, who also uses it for picnics. This use would be insufficient to claim adverse possession because it is neither continuous nor exclusive.

If the five tests are met, then the adverse possessor is entitled to legal title. If any one of the tests is missing, the adverse possession claim will fail.

Key Takeaway

Real property can be acquired without paying the lawful owner if five conditions of adverse possession are met: (1) the person claiming title by adverse possession must assert that he has a right to possession hostile to the interest of the original owner, (2) he must actually possess the property, (3) his possession must be "open and notorious," (4) the possession must be continuous, and (5) the possession must be exclusive.

Exercises

1. Tyler decides to camp out on a sandy beach lot near Isle of Palms, South Carolina. The owner, who had hoped to build a large house there, lived out of state. Tyler made no secret of his comings and goings, and after several weeks, when no one challenged his right to be there, he built a sturdy lean-to. After a while, he built a "micro house" and put a propane tank next to it. Although there was no running water, Tyler was plenty comfortable. His friends came often, they partied on the beach, and life was good. Five years after he first started camping out there, an agent of the owner came and told him to deconstruct his shelter and "move on." Does Tyler have any rights in the property? Why or why not?

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18.5: Summary and Exercises

Summary

Real property can be held in various forms of ownership. The most common forms are tenancy in common, joint tenancy, and tenancy by the entirety. Ten states recognize the community property form of ownership.

In selling real property, various common-law and statutory provisions come into play. Among the more important statutory provisions are the Civil Rights Acts of 1866 and 1968. These laws control the manner in which property may be listed and prohibit discrimination in sales. Sellers and buyers must also be mindful of contract and agency principles governing the listing agreement. Whether the real estate broker has an exclusive right to sell, an exclusive agency, or an open listing will have an important bearing on the fee to which the broker will be entitled when the property is sold.

The Statute of Frauds requires contracts for the sale of real property to be in writing. Such contracts must include the names of buyers and sellers, a description of the property, the price, and signatures. Unless the contract states otherwise, the seller must deliver marketable title, and the buyer will bear the loss if the property is damaged after the contract is signed but before the closing. The seller will usually insist on being paid earnest money, and the buyer will usually protect himself contractually against certain contingencies, such as failure to obtain financing. The contract should also specify the type of deed to be given to the buyer.

To provide protection to subsequent buyers, most states have enacted recording statutes that require buyers to record their purchases in a county office. The statutes vary: which of two purchasers will prevail depends on whether the state has a notice, notice-race, or race statute. To protect themselves, buyers usually purchase an abstract and opinion or title insurance. Although sale is the usual method of acquiring real property, it is possible to take legal title without the consent of the owner. That method is adverse possession, by which one who openly, continuously, and exclusively possesses property and asserts his right to do so in a manner hostile to the interest of the owner will take title in twenty years in most states.

Exercises

1. Rufus enters into a contract to purchase the Brooklyn Bridge from Sharpy. The contract provides that Sharpy is to give Rufus a quitclaim deed at the closing. After the closing, Rufus learns that Sharpy did not own the bridge and sues him for violating the terms of the deed. What is the result? Why?
2. Pancho and Cisco decide to purchase ten acres of real estate. Pancho is to provide 75 percent of the purchase price, Cisco the other 25 percent. They want to use either a joint tenancy or tenancy in common form of ownership. What do you recommend? Why?
3. Suppose in Exercise 2 that a friend recommends that Pancho and Cisco use a tenancy by the entirety. Would this form of ownership be appropriate? Why?
4. Richard and Elizabeth, a married couple, live in a community property state. During their marriage, they save $500,000 from Elizabeth's earnings. Richard does not work, but during the marriage, he inherits $500,000. If Richard and Elizabeth are divorced, how will their property be divided? Why?
5. Jack wants to sell his house. He hires Walter, a real estate broker, to sell the house and signs an exclusive-right-to-sell listing agreement. Walter finds a buyer, who signs a sales contract with Jack. However, the buyer later refuses to perform the contract because he cannot obtain financing. Does Jack owe a commission to Walter? Why?
6. Suppose in Exercise 5 that Jack found the buyer, the buyer obtained financing, and the sale was completed. Does Jack owe a commission to Walter, who provided no assistance in finding the buyer and closing the deal? Why?
7. Suppose in Exercise 5 that Jack's house is destroyed by fire before the closing. Who bears the loss—Jack or the buyer? Must Jack pay a commission to Walter? Why?
8. Suppose in Exercise 5 that the buyer paid $15,000 in earnest money when the contract was signed. Must Jack return the earnest money when the buyer learns that financing is unavailable? Why?

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CHAPTER OVERVIEW

19: Landlord and Tenant Laws

Learning Objectives

After reading this chapter, you should understand the following:

- The various types of leasehold estates
- How leasehold states are created and extended
- The rights and duties of landlords
- The rights and duties of tenants
- The potential tort liability of landlords

19.1: Types and Creation of Leasehold Estates
19.2: Rights and Duties of Landlords and Tenants
19.3: Summary and Exercises

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19.1: Types and Creation of Leasehold Estates

Learning Objectives

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

- Distinguish between the different types of leasehold estates.
- Describe how leasehold states can be created, both orally and in writing, and the requirements for creating leases that last for more than one year.

Real property can be divided into types of interests: freehold estates and leasehold estates. The freehold estate is characterized by indefinite duration, and the owner has title and the right to possess. The leasehold estate, by contrast, lasts for a specific period. The owner of the leasehold estate—the tenant—may take possession but does not have title to the underlying real property. When the period of the leasehold ends, the right to possession reverts to the landlord—hence the landlord's interest during the tenant's possession is known as a **reversionary interest**. Although a leasehold estate is said to be an interest in real property, the leasehold itself is in fact personal property. The law recognizes three types of leasehold estates: the estate for years, the periodic tenancy, and the tenancy at will.

Types of Leasehold Estates

Estate for Years

The estate for years is characterized by a definite beginning and a definite end. When you rent an apartment for two years, beginning September 1 and ending on the second August 31, you are the owner of an estate for years. Virtually any period will do; although it is called an estate "for years," it can last but one day or extend one thousand years or more. Some statutes declare that any estate for years longer than a specified period—one hundred years in Massachusetts, for instance—is a fee simple estate.

Unless the lease—the agreement creating the leasehold interest—provides otherwise, the estate for years terminates automatically at midnight of the last day specified in the lease. The lease need not refer explicitly to calendar dates. It could provide that "the tenant may occupy the premises for six months to commence one week from the date of signing." Suppose the landlord and tenant sign on June 23. Then the lease term begins at 12:00 a.m. on July 1 and ends just before midnight of December 31. Unless a statute provides otherwise, the landlord is not obligated to send the tenant a notice of termination. Should the tenant die before the lease term ends, her property interest can be inherited under her will along with her other personal property or in accordance with the laws of intestate succession.

Periodic Tenancy

As its name implies, a periodic tenancy lasts for a period that is renewed automatically until either landlord or tenant notifies the other that it will end. The periodic tenancy is sometimes called an estate from year to year (or month to month, or week to week). The lease may provide explicitly for the periodic tenancy by specifying that at the expiration of, say, a one-year lease, it will be deemed renewed for another year unless one party notifies the other to the contrary within six months prior to the expiration of the term. Or the periodic tenancy may be created by implication, if the lease fails to state a term or is defective in some other way, but the tenant takes possession and pays rent. The usual method of creating a periodic tenancy occurs when the tenant remains on the premises ("holds over") when an estate for years under a lease has ended. The landlord may either reject or accept the implied offer by the tenant to rent under a periodic tenancy. If he rejects the implied offer, the tenant may be ejected, and the landlord is entitled to rent for the holdover period. If he accepts the offer, the original lease determines the rent and length of the renewable period, except that no periodic tenancy may last longer than from year to year—that is, the renewable period may never be any longer than twelve months.

At common law, a party was required to give notice at least six months prior to the end of a year-to-year tenancy, and notice equal to the term for any other periodic tenancy. In most states today, the time period for giving notice is regulated by statute. In most instances, a year-to-year tenancy requires a month's notice, and shorter tenancies require notice equal to the term. To illustrate the approach typically used, suppose Simone rents from Anita on a month-to-month tenancy beginning September 15. On March 30, Simone passes the orals for her doctorate and decides to leave town. How soon may she cancel her tenancy? If she calls Anita that

afternoon, she will be two weeks shy of a full month's notice for the period ending April 15, so the earliest she can finish her obligation to pay rent is May 15. Suppose her term had been from the first of each month. On April 1, she notifies Anita of her intention to leave at the end of April, but she is stuck until the end of May, because notice on the first of the month is not notice for a full month. She would have had to notify Anita by March 31 to terminate the tenancy by April 30.

Tenancy at Will

If the landlord and tenant agree that the lease will last only as long as both want it to, then they have created a tenancy at will. Statutes in most states require some notice of intention to terminate. Simone comes to the university to study, and Anita gives her a room to stay in for free. The arrangement is a tenancy at will, and it will continue as long as both want it to. One Friday night, after dinner with classmates, Simone decides she would rather move in with Bob. She goes back to her apartment, packs her suitcase, and tells Anita she's leaving. The tenancy at will terminates that day.

Creation of Leasehold Estates

Oral Leases

Leases can be created orally, unless the term of the lease exceeds the period specified by the Statute of Frauds. In most states, including California, that period is one year. Any oral lease for a period longer than the statutory period is invalid. Suppose that Simone, in a state with a one-year Statute of Frauds period, orally agrees with Anita to rent Anita's apartment for two years, at a monthly rent of $250. The lease is invalid, and either could repudiate it.

Written Leases

A lease required to be in writing under the Statute of Frauds must contain the following items or provisions: (1) it must identify the parties, (2) it must identify the premises, (3) it must specify the duration of the lease, (4) it must state the rent to be paid, and (5) it must be signed by the party against whom enforcement is sought (known as "the party to be charged").

The provisions need not be perfectly stated. As long as they satisfy the five requirements, they will be adequate to sustain the lease under the Statute of Frauds. For instance, the parties need not necessarily be named in the lease itself. Suppose that the prospective tenant gives the landlord a month's rent in advance and that the landlord gives the tenant a receipt listing the property and the terms of the lease but omitting the name of the tenant. The landlord subsequently refuses to let the tenant move in. Who would prevail in court? Since the tenant had the receipt in her possession, that would be sufficient to identify her as the tenant to whom the terms of the lease were meant to apply. Likewise, the lease need not specify every aspect of the premises to be enjoyed. Thus the tenant who rents an apartment in a building will be entitled to the use of the common stairway, the roof, and so on, even though the lease is silent on these points. And as long as a specific amount is ascertainable, the rent may be stated in other than absolute dollar terms. For example, it could be expressed in terms of a cost-of-living index or as a percentage of the tenant's dollar business volume.

Key Takeaway

A leasehold estate, unlike a freehold estate, has a definite duration. The landlord's interest during the term of a leasehold estate is a reversionary interest. Leasehold estates can last for short terms or very long terms; in the case of long-term leases, a property right is created that can be passed to heirs. The usual landlord-tenant relationship is a periodic tenancy, which carries with it various common-law and statutory qualifications regarding renewal and termination. In a tenancy at will, either landlord or tenant can end the leasehold estate as soon as notice is provided by either party.

Exercises

1. What is the difference between a periodic tenancy and a tenancy at will?
2. What are the essential terms that must be in a written lease?

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19.2: Rights and Duties of Landlords and Tenants

Learning Objectives

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

- Itemize and explain the rights and duties of landlords.
- List and describe the rights and duties of tenants.
- Understand the available remedies for tenants when a landlord is in breach of his or her duties.

Rights and Duties of Landlords

The law imposes a number of duties on the landlord and gives the tenant a number of corresponding rights. These include (1) possession, (2) habitable condition, and (3) noninterference with use.

Possession

The landlord must give the tenant the right of possession of the property. This duty is breached if, at the time the tenant is entitled to take possession, a third party has paramount title to the property and the assertion of this title would deprive the tenant of the use contemplated by the parties. Paramount title means any legal interest in the premises that is not terminable at the will of the landlord or at the time the tenant is entitled to take possession.

If the tenant has already taken possession and then discovers the paramount title, or if the paramount title only then comes into existence, the landlord is not automatically in breach. However, if the tenant thereafter is evicted from the premises and thus deprived of the property, then the landlord is in breach. Suppose the landlord rents a house to a doctor for ten years, knowing that the doctor intends to open a medical office in part of the home and knowing also that the lot is restricted to residential uses only. The doctor moves in. The landlord is not yet in default. The landlord will be in default if a neighbor obtains an injunction against maintaining the office. But if the landlord did not know (and could not reasonably have known) that the doctor intended to use his home for an office, then the landlord would not be in default under the lease, since the property could have been put to normal—that is, residential—use without jeopardizing the tenant's right to possession.

Warranty of Habitability

As applied to leases, the old common-law doctrine of caveat emptor said that once the tenant has signed the lease, she must take the premises as she finds them. Since she could inspect them before signing the lease, she should not complain later. Moreover, if hidden defects come to light, they ought to be easy enough for the tenant herself to fix. Today this rule no longer applies, at least to residential rentals. Unless the parties specifically agree otherwise, the landlord is in breach of his lease if the conditions are unsuitable for residential use when the tenant is due to move in. The landlord is held to an implied warranty of habitability.

The change in the rule is due in part to the conditions of the modern urban setting: tenants have little or no power to walk away from an available apartment in areas where housing is scarce. It is also due to modem construction and technology: few tenants are capable of fixing most types of defects. A US court of appeals has said the following:

Today's urban tenants, the vast majority of whom live in multiple dwelling houses, are interested not in the land, but solely in "a house suitable for occupation." Furthermore, today's city dweller usually has a single, specialized skill unrelated to maintenance work; he is unable to make repairs like the "jack-of-all-trades" farmer who was the common law's model of the lessee. Further, unlike his agrarian predecessor who often remained on one piece of land for his entire life, urban tenants today are more mobile than ever before. A tenant's tenure in a specific apartment will often not be sufficient to justify efforts at repairs. In addition, the increasing complexity of today's dwellings renders them much more difficult to repair than the structures of earlier times. In a multiple dwelling, repairs may require access to equipment and areas in control of the landlord. Low and middle income tenants, even if they were interested in making repairs, would be unable to obtain financing for major repairs since they have no long-term interest in the property. (*Javins v. First National Realty Corp.*, 428 F.2d 1071, 1078-79 (D.C. Cir.).)

At common law, the landlord was not responsible if the premises became unsuitable once the tenant moved in. This rule was often harshly applied, even for unsuitable conditions caused by a sudden act of God, such as a tornado. Even if the premises collapsed, the tenant would be liable to pay the rent for the duration of the lease. Today, however, many states have statutorily abolished the

tenant's obligation to pay the rent if a non-man-made force renders the premises unsuitable. Moreover, most states today impose on the landlord, after the tenant has moved in, the responsibility for maintaining the premises in a safe, livable condition, consistent with the safety, health, and housing codes of the jurisdiction.

These rules apply only in the absence of an express agreement between the parties. The landlord and tenant may allocate in the lease the responsibility for repairs and maintenance. But it is unlikely that any court would enforce a lease provision waiving the landlord's implied warranty of habitability for residential apartments, especially in areas where housing is relatively scarce.

Noninterference with Use

In addition to maintaining the premises in a physically suitable manner, the landlord has an obligation to the tenant not to interfere with a permissible use of the premises. Suppose Simone moves into a building with several apartments. One of the other tenants consistently plays music late in the evening, causing Simone to lose sleep. She complains to the landlord, who has a provision in the lease permitting him to terminate the lease of any tenant who persists in disturbing other tenants. If the landlord does nothing after Simone has notified him of the disturbance, he will be in breach. This right to be free of interference with permissible uses is sometimes said to arise from the landlord's implied covenant of quiet enjoyment.

Tenant's Remedies

When the landlord breaches one of the foregoing duties, the tenant has a choice of three basic remedies: termination, damages, or rent adjustment.

In virtually all cases where the landlord breaches, the tenant may terminate the lease, thus ending her obligation to continue to pay rent. To terminate, the tenant must (1) actually vacate the premises during the time that she is entitled to terminate and (2) either comply with lease provisions governing the method of terminating or else take reasonable steps to ensure that the landlord knows she has terminated and why.

When the landlord physically deprives the tenant of possession, he has evicted the tenant; wrongful eviction permits the tenant to terminate the lease. Even if the landlord's conduct falls short of actual eviction, it may interfere substantially enough with the tenant's permissible use so that they are tantamount to eviction. This is known as constructive eviction, and it covers a wide variety of actions by both the landlord and those whose conduct is attributable to him.

Damages

Another traditional remedy is money damages, available whenever termination is an appropriate remedy. Damages may be sought after termination or as an alternative to termination. Suppose that after the landlord had refused Simone's request to repair the electrical system, Simone hired a contractor to do the job. The cost of the repair work would be recoverable from the landlord. Other recoverable costs can include the expense of relocating if the lease is terminated, moving costs, expenses connected with finding new premises, and any increase in rent over the period of the terminated lease for comparable new space. A business may recover the loss of anticipated business profits, but only if the extent of the loss is established with reasonable certainty. In the case of most new businesses, it would be almost impossible to prove loss of profits.

In all cases, the tenant's recovery will be limited to damages that would have been incurred by a tenant who took all reasonable steps to mitigate losses. That is, the tenant must take reasonable steps to prevent losses attributable to the landlord's breach, to find new space if terminating, to move efficiently, and so on.

Rent Remedies

Under an old common-law rule, the landlord's obligation to provide the tenant with habitable space and the tenant's obligation to pay rent were independent covenants. If the landlord breached, the tenant was still legally bound to pay the rent; her only remedies were termination and suit for damages. But these are often difficult remedies for the tenant. Termination means the aggravation of moving, assuming that new quarters can be found, and a suit for damages is time consuming, uncertain, and expensive. The obvious solution is to permit the tenant to withhold rent, or what we here call rent adjustment. The modern rule, adopted in several states (but not yet in most), holds that the mutual obligations of landlord and tenant are dependent. States following this approach have developed three types of remedies: rent withholding, rent application, and rent abatement.

The simplest approach is for the tenant to withhold the rent until the landlord remedies the defect. In some states, the tenant may keep the money. In other states, the rent must be paid each month into an escrow account or to the court, and the money in the escrow account becomes payable to the landlord when the default is cured.

Several state statutes, including California, permit the tenant to apply the rent money directly to remedy the defect or otherwise satisfy the landlord's performance. (Cal. Civ. Code, § 1942.) Thus Simone might have deducted from her rent the reasonable cost of hiring an electrician to repair the electrical system.

In some states, the rent may be reduced or even eliminated if the landlord fails to cure specific types of defects, such as violations of the housing code. The abatement will continue until the default is eliminated or the lease is terminated.

Rights and Duties of Tenants

In addition to the duties of the tenant set forth in the lease itself, the common law imposes three other obligations: (1) to pay the rent reserved (stated) in the lease, (2) to refrain from committing waste (damage), and (3) not to use the premises for an illegal purpose.

Duty to Pay Rent

What constitutes rent is not necessarily limited to the stated periodic payment usually denominated "rent." The tenant may also be responsible for such assessments as taxes and utilities, payable to the landlord as rent. Simone's lease calls for her to pay taxes of $500 per year, payable in quarterly installments. She pays the rent on the first of each month and the first tax bill on January 1. On April 1, she pays the rent but defaults on the next tax bill. She has failed to pay the rent reserved in the lease.

In California, a landlord has a duty to take reasonable steps to re-rent a property and limit its losses (otherwise known as "mitigating its damages") if a tenant abandons or breaks a lease. (Cal. Civ. Code, § 1951.2.) The landlord in the majority of states, however, is not obligated to mitigate his losses should the tenant abandon the property and fail thereafter to pay the rent. As a practical matter, this means that the landlord need not try to rent out the property but instead can let it sit vacant and sue the defaulting tenant for the balance of the rent as it becomes due. However, the tenant might notify the landlord that she has abandoned the property or is about to abandon it and offer to surrender it. If the landlord accepts the surrender, the lease then terminates. Unless the lease specifically provides for it, a landlord who accepts the surrender will not be able to recover from the tenant the difference between the amount of her rent obligation and the new tenant's rent obligation.

Many leases require the tenant to make a security deposit—a payment of a specific sum of money to secure the tenant's performance of duties under the lease. If the tenant fails to pay the rent or otherwise defaults, the landlord may use the money to make good the tenant's performance. Whatever portion of the money is not used to satisfy the tenant's obligations must be repaid to the tenant at the end of the lease. In the absence of an agreement to the contrary, the landlord must pay interest on the security deposit when he returns the sum to the tenant at the end of the lease.

Alteration and Restoration of the Premises

In the absence of a specific agreement in the lease, the tenant is entitled to physically change the premises in order to make the best possible permissible use of the property, but she may not make structural alterations or damage (waste) the property. A residential tenant may add telephone lines, put up pictures, and affix bookshelves to the walls, but she may not remove a wall in order to enlarge a room.

The tenant must restore the property to its original condition when the lease ends, but this requirement does not include normal or reasonable wear and tear. Simone rents an apartment with newly polished wooden floors. Because she likes the look of oak, she decides against covering the floors with rugs. In a few months' time, the floors lose their polish and become scuffed. Simone is not obligated to refinish the floors, because the scuffing came from normal walking, which is ordinary wear and tear.

Use of the Property for an Illegal Purpose

It is a breach of the tenant's obligation to use the property for an illegal purpose. A landlord who found a tenant running a numbers racket, for example, or making and selling moonshine whisky could rightfully evict her.

Landlord's Remedies

In general, when the tenant breaches any of the three duties imposed by the common law, the landlord may terminate the lease and seek damages. One common situation deserves special mention: the holdover tenant. When a tenant improperly overstays her lease, she is said to be a tenant at sufferance, meaning that she is liable to eviction. Some cultures, like the Japanese, exhibit a considerable bias toward the tenant, making it exceedingly difficult to move out holdover tenants who decide to stay. But in the United States, landlords may remove tenants through summary (speedy) proceedings available in every state or, in some cases, through self-help. Self-help is a statutory remedy for landlords or incoming tenants in some states and involves the peaceful removal of a holdover tenant's belongings. Self-help by landlords (such as changing locks, shutting off utilities, or removing belongings) is illegal in California. (Cal. Civ. Code, § 789.3.) Landlords in California must proceed under the state's unlawful detainer process wherein a tenant is notified through a court action that the tenant may be evicted by the sheriff. If a state has a statute providing a summary procedure for removing a holdover tenant, neither the landlord nor the incoming tenant may resort to self-help, unless the statute specifically allows it. A provision in the lease permitting self-help in the absence of statutory authority is unenforceable. Self-help must be peaceful, must not cause physical harm or even the expectation of harm to the tenant or anyone on the premises with his permission, and must not result in unreasonable damage to the tenant's property. Any clause in the lease attempting to waive these conditions is void.

Self-help can be risky, because some summary proceeding statutes declare it to be a criminal act and because it can subject the landlord to tort liability. Suppose that Simone improperly holds over in her apartment. With a new tenant scheduled to arrive in two days, the landlord knocks on her door the evening after her lease expires. When Simone opens the door, she sees the landlord standing between two 450-pound Sumo wrestlers with menacing expressions. He demands that she leave immediately. Fearing for her safety, she departs instantly. Since she had a reasonable expectation of harm had she not complied with the landlord's demand, Simone would be entitled to recover damages in a tort suit against her landlord, although she would not be entitled to regain possession of the apartment.

Besides summary judicial proceedings and self-help, the landlord has another possible remedy against the holdover tenant: to impose another rental term. In order to extend the lease in this manner, the landlord need simply notify the holdover tenant that she is being held to another term, usually measured by the periodic nature of the rent payment. For example, if rent was paid each month, then imposition of a new term results in a month-to-month tenancy. One year is the maximum tenancy that the landlord can create by electing to hold the tenant to another term.

Key Takeaway

Both landlords and tenants have rights and duties. The primary duty of a landlord is to meet the implied warranty of habitability: that the premises are in a safe, livable condition. The tenant has various remedies available if the landlord fails to meet that duty, or if the landlord fails to meet the implied covenant of quiet enjoyment. These include termination, damages, and withholding of rent. The tenant has duties as well: to pay the rent, refrain from committing waste, and not use the property for an illegal purpose.

Exercises

1. Consistent with the landlord's implied warranty of habitability, can the landlord and tenant agree in a lease that the tenant bear any and all expenses to repair the refrigerator, the stove, and the microwave?
2. Under what conditions is it proper for a tenant to withhold rent from the landlord?

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19.3: Summary and Exercises

Summary

A leasehold is an interest in real property that terminates on a certain date. The leasehold itself is personal property and has three major forms: (1) the estate for years, (2) the periodic tenancy, and (3) the tenancy at will. The estate for years has a definite beginning and end; it need not be measured in years. A periodic tenancy—sometimes known as an estate from year to year or month to month—is renewed automatically until either landlord or tenant notifies the other that it will end. A tenancy at will lasts only as long as both landlord and tenant desire. Oral leases are subject to the Statute of Frauds. In most states, leases to last longer than a year must be in writing, and the lease must identify the parties and the premises, specify the duration, state the rent, and be signed by the party to be charged.

The law imposes on the landlord certain duties toward the tenant and gives the tenant corresponding rights, including the right of possession, habitable condition, and noninterference with use. The right of possession is breached if a third party has paramount title at the time the tenant is due to take possession. In most states, a landlord is obligated to provide the tenant with habitable premises not only when the tenant moves in but also during the entire period of the lease. The landlord must also refrain from interfering with a tenant's permissible use of the premises.

If the landlord breaches an obligation, the tenant has several remedies. He may terminate the lease, recover damages, or (in several states) use a rent-related remedy (by withholding rent, by applying it to remedy the defect, or by abatement).

The tenant has duties also. The tenant must pay the rent. If she abandons the property and fails to pay, most states do not require the landlord to mitigate damages, but several states are moving away from this general rule. The tenant may physically change the property to use it to her best advantage, but she may not make structural alterations or commit waste. The tenant must restore the property to its original condition when the lease ends. This rule does not include normal wear and tear.

Should the tenant breach any of her duties, the landlord may terminate the lease and seek damages. In the case of a holdover tenant, the landlord may elect to hold the tenant to another rental term.

The interest of either landlord or tenant may be transferred freely unless the tenancy is at will, the lease requires either party to perform significant personal services that would be substantially less likely to be performed, or the parties agree that the interest may not be transferred.

Despite the general rule that the tenant is responsible for injuries caused on the premises to outsiders, the landlord may have significant tort liability if (1) there are hidden dangers he knows about, (2) defects that existed at the time the lease was signed injure people off the premises, (3) the premises are rented for public purposes, (4) the landlord retains control of the premises, or (5) the landlord repairs the premises in a faulty manner.

Exercises

1. Lanny orally agrees to rent his house to Tenny for fifteen months, at a monthly rent of $1,000. Tenny moves in and pays the first month's rent. Lanny now wants to cancel the lease. May he? Why?
2. Suppose in Exercise 1 that Tenny had an option to cancel after one year. Could Lanny cancel before the end of the year? Why?
3. Suppose in Exercise 1 that Lanny himself is a tenant and has leased the house for six months. He subleases the house to Tenny for one year. The day before Tenny is to move into the house, he learns of Lanny's six-month lease and attempts to terminate his one-year lease. May he? Why?
4. Suppose in Exercise 3 that Tenny learned of Lanny's lease the day after he moved into the house. May he terminate? Why?
5. Simon owns a four-story building and rents the top floor to a college student. Simon is in the habit of burning refuse in the backyard, and the smoke from the refuse is so noxious that it causes the student's eyes to water and his throat to become raw. Has Simon breached a duty to the student? Explain.
6. In Exercise 5, if other tenants (but not Simon) were burning refuse in the backyard, would Simon be in breach? Why?
7. Assume in Exercise 5 that Simon was in breach. Could the student move out of the apartment and terminate the lease? What effect would this have on the student's duty to pay rent? Explain.

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