INTRODUCTION TO PARALEGAL STUDIES AND ETHICS



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Introduction to Paralegal Studies and Ethics

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This text was compiled on 08/23/2026

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1: INTRODUCTION TO THE PARALEGAL PROFESSION

1.1: The Paralegal Profession
1.2: Growth of the paralegal profession
1.3: Understanding the distinctness of different legal environments
1.4: Alternate career paths
1.5: The Culture of Law
1.6: The Paralegal Profession

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1.1: The Paralegal Profession

Introduction to the Paralegal Profession

This reading is an introduction to the paralegal profession. The profession is related to the legal profession so it is a para profession. It is not regulated or licensed like lawyers are and that is a topic for discussion. Paralegals are supervised by lawyers. Looking at the profession in light of the legal profession is useful.

However, the skills of the paralegal are valuable outside the law firm. Paralegals with experience in contract law work as Contract Managers in the defense industry. Those with paralegal training work in corporate offices and in the legal departments of highly regulated industries. Courts, counties, and government agencies are regulated and an individual who understands the law and how to research it has valuable skills.

We will learn about law firms and the lawyers who supervise paralegals in this textbook. We will do that and also remember how valuable a paralegal certificate and education can be just in the aquisition of legal literacy and in diverse employment settings.

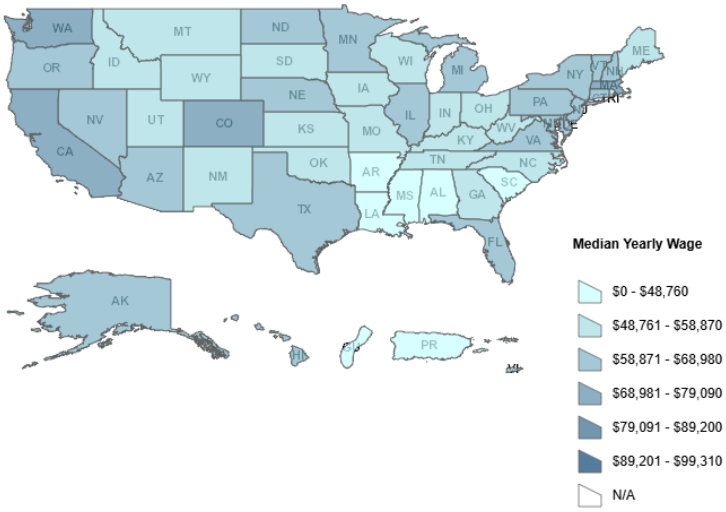
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1.2: Growth of the paralegal profession

Growth of the paralegal profession

Paralegals and Legal Assistants : Occupational Outlook Handbook: : U.S. Bureau of Labor Statistics

https://www.careeronestop.org/Videos/careeronestop-videos.aspx?videocode=23201100&op=y



Occupation Description

Paralegals and Legal Assistants

Assist lawyers by investigating facts, preparing legal documents, or researching legal precedent. Conduct research to support a legal proceeding, to formulate a defense, or to initiate legal action.

The graphic above exhibits the profession across the US. Each state is a distinct legal environment because each state regulates its own attorneys who employ paralegals.

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1.3: Understanding the distinctness of different legal environments

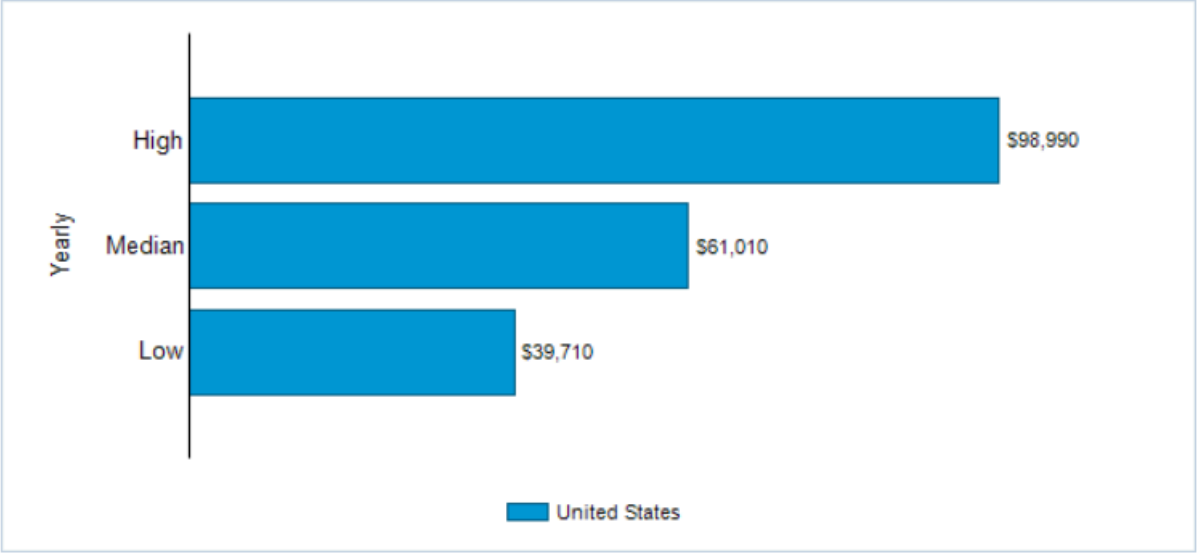
Understanding distinct legal environments

Urban vs. rural

- This determines who the legal consumer will be people, industry, government

Terrain - rivers, lakes, mountains, beach, forest,

- This will determine industry in the area and that will impact the legal service providers and the focus on law in that area
- Environmental law
- Logging industry
- Logistics like the Port of Long Beach - shipping, maritime,



The image above displays wages for the profession in the US

The graphic below focuses on California and paralegal wages.



What kinds of questions do these images raise in your mind?

How to interpret data: Extrapolation to give clues

To extrapolate means to make an educated guess about the unknown by looking at the facts you already have. It involves extending a known pattern into the future or to a new situation

- **Cost of Living:** Urban coastal regions, such as the San Francisco Bay Area or New York City, typically have a much higher cost of housing, transportation, and services. Employers must offer higher wages to attract and retain staff in these expensive markets.
- **Concentration of Large Law Firms:** Major metropolitan areas on the coasts are home to many "Big Law" firms and large corporate headquarters. these organizations often have larger legal budgets and handle complex, high-stakes litigation or transactions that command higher billing rates, which can translate to higher paralegal salaries.
- **Market Demand and Specialization:** These regions often have a high density of legal activity. The demand for experienced paralegals—especially those with niche expertise in areas like intellectual property, international law, or high-level corporate finance—is often greater in these hubs than in rural or inland areas.

Simple examples of extrapolation based on the wage data exhibited above:

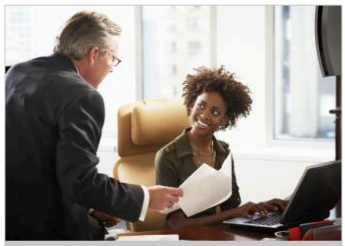
Paralegals earn more in urban areas

1. Those areas will have more legal services consumers
2. Those areas have more legal conflict needing resolution.
3. Those same areas have a bigger concentration of courts
4. Those areas have a higher cost of living
5. Those areas have more competition for jobs
6. Legal disputes may be more complex in those areas
7. Also, people living there need everyday legal services because the population is just larger

What Paralegals and Legal Assistants Do

About this section

Paralegals and legal assistants support lawyers by performing a variety of tasks, such as maintaining and organizing files, conducting legal research, and drafting documents.



Paralegals and legal assistants may conduct legal research.

Duties

Paralegals and legal assistants typically do the following:

- Investigate and gather the facts of a case
- Research laws, regulations, and legal articles that are relevant to a case
- Gather, organize, and maintain legal documents
- Draft correspondence and legal documents, such as confirmation letters and contracts
- Obtain affidavits and other formal statements that may be used as evidence in court
- Help lawyers during trials with tasks such as handling exhibits, taking notes, or reviewing trial transcripts
- File exhibits, briefs, appeals, and other legal documents with the appropriate court, government agency, or opposing counsel
- Call clients, witnesses, lawyers, and others to schedule interviews, meetings, and depositions

Paralegals and legal assistants help lawyers prepare for hearings, trials, and other proceedings. For example, they may conduct legal research, write reports and other documents, and file materials related to trials or cases.

Specific duties for paralegals and legal assistants may vary depending on the area, such as bankruptcy or intellectual property, or type of law in which they work. For example, in litigation, paralegals and legal assistants may help lawyers to prepare for trial, such as by researching case law and drafting documents, and to coordinate trial logistics, including by transporting exhibits to the courtroom and setting up equipment.

Paralegals' and legal assistants' roles also may vary based on the size of the firm that employs them. In small firms, for example, they may work on all aspects of a case from beginning to end. In larger firms, they may work on a particular phase of a case, such as helping to prepare witnesses for deposition or trial.

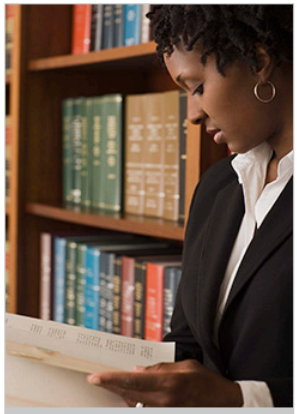
Paralegals and Legal Assistants : Occupational Outlook Handbook: : U.S. Bureau of Labor Statistics

Work Environment

About this section

Paralegals and legal assistants held about 376,200 jobs in 2024. The largest employers of paralegals and legal assistants were as follows:

Legal services	74%
Local government, excluding education and hospitals	5
Federal government, excluding postal service	5
Finance and insurance	3
State government, excluding education and hospitals	3



Most paralegals and legal assistants work in law offices.

Paralegals and legal assistants often work on teams with attorneys and other legal support staff.

Paralegals and legal assistants work primarily in offices. Occasional travel may be required, such as to accompany attorneys to depositions or trials.

Their work may be stressful because it can be fast paced, and they may be required to work on multiple projects simultaneously under tight deadlines.

Work Schedules

Most paralegals and legal assistants work full time.

You will learn many new skills as a paralegal. Those skills are valuable in many different jobs. Throughout your learning hopefully we will be able to demonstrate how the skills you learn and exercise create value of course for the law firm but also for industries that must comply with regulations, or needs to file forms, research the law, and investigate matters.

Transferable paralegal skills for other occupations:

- Writing
- Research
- Analysis
- Organization
- Attention to detail

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1.4: Alternate career paths

15 Alternative Career Paths for Paralegals:

1. Heavily regulated industries - financial services, mortgage, brokerage, chemical, medical
2. Legal Staffing Recruiter
3. Pro Bono Program Coordinator
4. Project Manager for legal support vendor
5. County government agency - compliance related departments
6. Mediator
7. Foreclosure Specialist
8. Contracts Administrator
9. Compliance Specialist

Alternative Paralegal Career Options - Ann Pearson

Paralegal training offers a versatile foundation that allows professionals to transition into a wide array of specialized roles across various industries. By leveraging existing skills from prior careers, individuals can pursue leadership positions in office management, law firm administration, or educational consulting. The legal background acquired is also highly applicable to sectors like banking, healthcare, and real estate, where specialized knowledge of regulations and documentation is essential. Beyond traditional law firms, opportunities exist in government lobbying, social service advocacy, and even technical roles such as computer systems management. Ultimately, becoming a paralegal serves as a strategic stepping stone for long-term career growth, providing the flexibility to remain in the legal field or pivot toward alternative high-paying professions. Understanding these diverse paths helps practitioners set long-term professional goals that align with their personal talents and interests.

Paralegal training provides a versatile skill set that is highly valued across numerous sectors outside of traditional law firms. Based on the sources, industries and fields that frequently hire individuals with this training include:

- **Financial Services and Banking:** Banks hire banking specialists to handle evolving domestic and foreign regulations. Opportunities also exist in stock brokerage and importing/exporting firms.
- **Corporate Environments:** Corporations employ corporate specialists to work in specialized areas such as patent and trademark divisions or employee benefits offices.
- **Government and Public Policy:** Paralegals are well-suited for careers in lobbying, politics, and government regulatory issues. Many also find roles within civil service.
- **Real Estate and Insurance:** The real estate industry offers positions in title and mortgage companies, as well as real estate sales and management. Insurance agencies (both medical and non-medical) also hire paralegals for specialized roles.
- **Healthcare:** Within hospital settings, paralegals can work as medical specialists, helping organizations navigate changing healthcare policies.
- **Social Services and Nonprofits:** Agencies focused on immigration services, the criminal justice system, or the social welfare system frequently hire for roles that require paralegal skills. For example, an Immigrant Specialist may act as a court advocate, a role that essentially performs paralegal work.
- **Education and Academia:** Paralegals can work as teachers, program administrators, or consultants. They may also serve as education coordinators for continuing legal education (CLE) programs at colleges and universities.
- **Technology and Information Management:** Those with computer literacy may become computer center managers, overseeing information systems, word processing, and electronic data banks. Additionally, law librarianship is a common path

for those trained to manage legal manuals and periodical collections.

- **Journalism and Communications:** Individuals with strong research and writing skills can find opportunities as journalists for companies that prioritize legal expertise.
- **Sales and General Management:** The legal supply industry hires people with paralegal backgrounds to sell equipment and materials to attorneys. Furthermore, **office management** roles in various non-legal industries are open to those with strong supervisory and administrative skills.

While some of these roles may require additional specialized training or credentials, a paralegal background serves as a significant asset and a stepping stone or entry to these diverse career paths.

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1.5: The Culture of Law

The Culture of Law

The culture of law is conservative. That is not a political statement. This means things are serious and rarely truly informal. There may be casual dress Friday but at all times there is an undercurrent of formality. This is particularly true of law firms. Corporate legal offices may have more variety depending on the business.

Understanding legal information

Sometimes you will review documents that courts write, sometimes practice forms, and sometimes advice from the State Bar Associations. How do you approach information you know nothing about?

- Approach with curiosity and not as an enemy combatant of information
- Look for clues about what things mean.
- Free yourself to be wrong and able to pivot

Here are the California Attorney Guidelines of Civility and Professionalism

Please open the document linked above and skim.

Here is an excerpt to consider:

... [these ellipse mean that this is an excerpt and not all content is included here]

Section 4

Communication

....

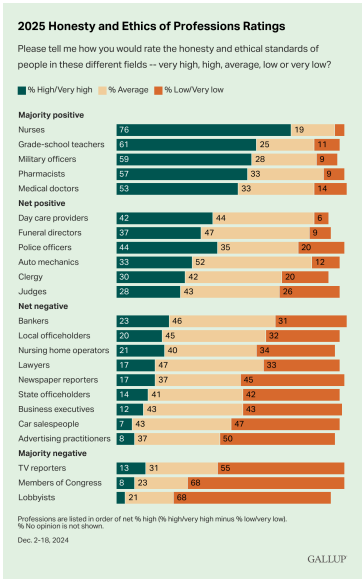
C. An attorney should not disparage the intelligence, integrity, ethics, morals or behavior of the court or other counsel, parties or participants when those characteristics are not at issue.

D. Respecting cultural diversity, an attorney should not disparage another's personal characteristics.

E. An attorney should not make exaggerated, false, or misleading statements to the media while representing a party in a pending matter.

F. An attorney should avoid hostile, demeaning or humiliating words.

https://news.gallup.com/poll/655106/...cally-low.aspx



The graphic above is a Gallup poll of everyday people's perception of ethics and honesty in professions. Where does the lawyer fall on the graph?

Questions

1. You've reviewed some of the California Attorney Guidelines of Civility and Professionalism and looked at the US perception of ethics and honesty among professions. Lawyers were a net negative but not at the bottom.Why are lawyers perceived so negatively in terms of ethics and honesty when they must adhere to such a strict Code of Ethics and civility?

2. Look at the professions that land near lawyers. Can you make any deductions or observations about why those professions also are a net negative? Are there any similarities with the legal profession regarding truth telling or ethical behavior?

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1.6: The Paralegal Profession

The Paralegal Profession

Paraprofessional

A person who works within a profession in a subordinate position but with special training and a degree of independence in carrying out duties





How do paralegals bill their time?

Paralegals can bill for their substantive legal work similarly to attorneys, but typically at lower hourly rates than lawyers. In fact, most paralegals bill hourly and directly to clients.

Paralegals billing hourly must know how to log portions of hours worked accurately. To quickly track and calculate hours without cutting yourself short o padding your time, both lawyers and paralegals bill in standard time increments

3. Commitment to the Highest Standards of Ethical Conduct

Paralegals should know the rules of ethics that bind lawyers and understand how these rules apply to them. They should also develop their own personal standards of ethics and morality that reach beyond the minimums imposed by law. Paralegals must be scrupulously honest in their relations with clients, courts, attorneys, co-workers, and others in their professional world.

4. Commitment to Excellence

Paralegals should set high standards of performance for themselves and seek to meet those standards in all the work they undertake. They should approach each task with an attitude of seriousness and apply diligently their knowledge, skill, and talent to accomplish their work.

5. Commitment to the Paralegal Profession

Paralegals are part of a distinct profession within the legal field, with interests and goals that are shared by other paralegals. They should support paralegal activities organized through professional associations, bar associations, and alumni associations. They should also engender collegiality among their colleagues, mentoring new paralegals and acting as a role model and source of information for those who aspire to the paralegal profession.

6. Commitment to a Strong Work Ethic

Paralegals should strive to do their best on every task and to serve clients diligently. They should be meticulous and thorough, organized, prompt in meeting deadlines, and always do more than the minimum. They should take pride in their work and always do work that merits that pride.

1. Commitment to Public Service

Paralegals should always remember that their highest goal is to assist in the delivery of legal services to the public, legal services that are delivered ethically, competently, and efficiently. In addition to being reflected in their daily work lives, this commitment also requires paralegals to engage in activities that improve access to legal services, such as pro bono programs. See Section D later in this chapter.

2. Commitment to Education

Fulfilling this commitment includes participating in formal education, continuing education, and on-the-job learning that enhance knowledge and skills and continually develop the paralegal's potential. Education heightens the paralegal's ability to deliver quality legal services and enriches long-term career satisfaction.

7. Commitment to Acting with Integrity and Honor

Paralegals should be courteous, respectful, and fair in their dealings with lawyers, other paralegals, support staff, clients, and others both within and outside their firm. They should demonstrate maturity, patience, and thoughtfulness in their actions, avoiding gossip, undue criticism of others, prejudice, and favoritism. This commitment means being sensitive to the needs and talents of others, valuing the differences in people's backgrounds, and recognizing others' achievements.

8. Commitment to Balance as a Person

Paralegals should not become so consumed by their work that they neglect other aspects of their lives, such as family, friends, health, and personal interests and activities. They should seek to be well rounded and should have a variety of interests. Commitment to a profession need not prevent a person from leading a full life; in fact, a person who narrows his or her interests only to work will not be as effective in relations with others and will not possess the sense of proportion and balance needed to fulfill his or her commitments as a professional.

9. Commitment to Good Judgment, Common Sense, and Communication

Paralegals should strive to understand and work well with others. They should listen to others carefully and communicate, both orally and in writing, clearly and persuasively.

There are paralegal professional organizations that provide a Code of Ethics and Professional Responsibility. Unlike lawyers, paralegals are not regulated or licensed.

NALA | THE PARALEGAL ASSOCIATION
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NALA Code of Ethics and Professional Responsibility

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National Association of Legal Assistants, Inc.**

Each NALA member agrees to follow the canons of the NALA Code of Ethics and Professional Responsibility. Violations of the Code may result in cancellation of membership. First adopted by the NALA membership in May of 1975, the Code of Ethics and Professional Responsibility is the foundation of ethical practices of paralegals in the legal community.

A paralegal must adhere strictly to the accepted standards of legal ethics and to the general principles of proper conduct. The performance of the duties of the paralegal shall be governed by specific canons as defined herein, so that justice will be served, and goals of the profession attained. (See Model Standards and Guidelines for Utilization of Paralegals, Section II.)

The canons of ethics set forth hereafter are adopted by the National Association of Legal Assistants, Inc., as a general guide intended to aid paralegals and attorneys. The enumeration of these rules does not mean there are not others of equal importance although not specifically mentioned. Court rules, agency rules, and statutes must be taken into consideration when interpreting the canons.

Definition: Paralegals are a distinguishable group of persons who assist attorneys in the delivery of legal services. Through formal education, training, and experience, paralegals have knowledge and expertise regarding the legal system and substantive and procedural law which qualify them to do work of a legal nature under the supervision of an attorney.

In 2001, NALA members also adopted the ABA definition of a legal assistant/paralegal, as follows:

"A legal assistant or paralegal is a person qualified by education, training or work experience who is employed or retained by a lawyer, law office, corporation, governmental agency, or other entity who performs specifically delegated substantive legal work for which a lawyer is responsible." (Adopted by the ABA in 1997)

The ABA adopted a revised definition in 2020, removing the term "legal assistant." NALA realizes that the terms legal assistant and paralegal are used in the United States. NALA recognizes and supports paralegals, regardless of title; however, as an organization, we primarily use the term paralegal.

Canon 1.
A paralegal must not perform any of the duties that attorneys only may perform nor take any actions that attorneys may not take.

Canon 2.
A paralegal may perform any task which is properly delegated and supervised by an attorney, as long as the attorney is ultimately responsible to the client, maintains a direct relationship with the client, and assumes professional responsibility for the work product.

Canon 3.
A paralegal must not: (a) engage in, encourage, or contribute to any act which could constitute the unauthorized practice of law; (b) establish attorney-client relationships, set fees, give legal opinions or advice, or represent a client before a court or agency unless so authorized by that court or agency; and (c) engage in conduct or take any action which would assist or involve the attorney in a violation of professional ethics or give the appearance of professional impropriety.

Canon 4.
A paralegal must use discretion and professional judgment commensurate with knowledge and experience but must not render independent legal judgment in place of an attorney. The services of an attorney are essential to the public interest whenever such legal judgment is required.

Canon 5.
A paralegal must disclose status as a paralegal at the outset of any professional relationship with a client, attorney, a court or administrative agency or personnel thereof, or a member of the general public. A paralegal must act prudently in determining the extent to which a client may be assisted without the presence of an attorney.

Canon 6.
A paralegal must strive to maintain integrity and a high degree of competency through education and training with respect to professional responsibility, local rules and practice, and through continuing education in substantive areas of law to better assist the legal profession in fulfilling its duty to provide legal service.

Canon 7.
A paralegal must protect the confidences of a client and must not violate any rule or statute now in effect or hereafter enacted controlling the doctrine of privileged communications between a client and an attorney.

Canon 8.
A paralegal must disclose to an employer or prospective employer any pre-existing client or personal relationship that may conflict with the interests of the employer or prospective employer and/or their clients.

Canon 9.
A paralegal must do all other things incidental, necessary, or expedient for the attainment of the ethics and responsibilities as defined by statute or rule of court.

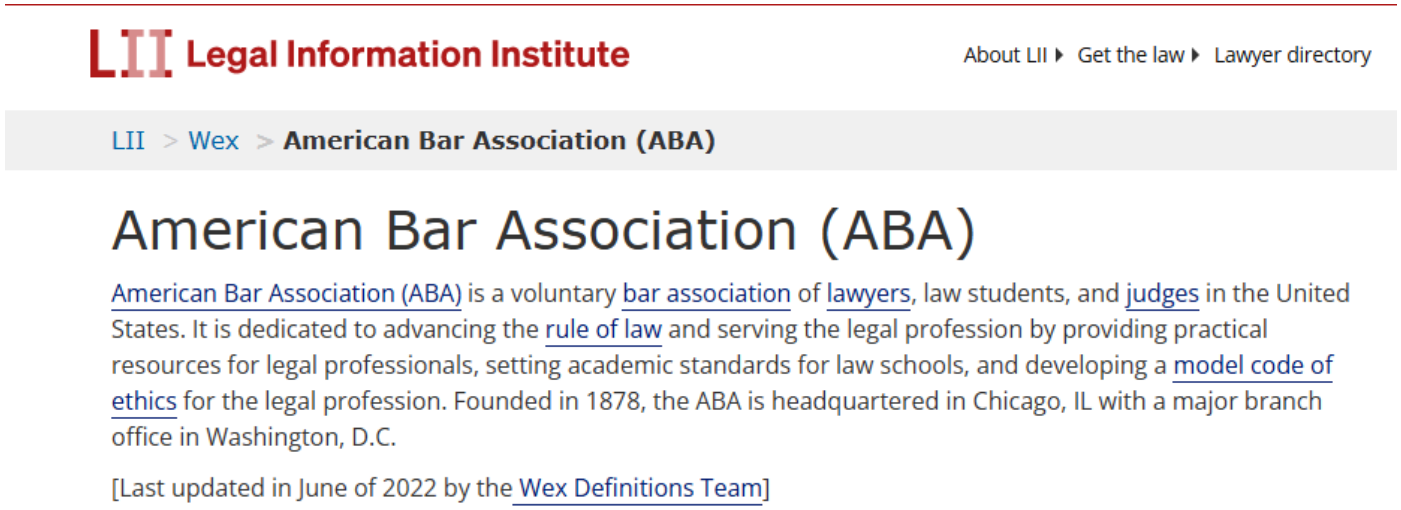
Canon 10.
A paralegal's conduct is guided by bar associations' codes of professional responsibility and rules of professional conduct.

ABA®
AMERICANBARASSOCIATION

The American Bar Association (ABA) is a professional group that lobbies for the legal profession. They also promulgate model ethical rules that states may adopt or not. They provide standards for legal education and paralegal education. But some could say they have failed to promote paralegals in a meaningful way, seeing them instead as a competition for other legal services providers.

The debate around whether to regulate paralegals has raised many difficult questions:

- Is there a need for regulation?
- Who should be regulated?
- Who should do the regulating?
- Should regulation be mandatory?
- What level of regulation is appropriate?
- What educational requirements should be established?
- What kind of examination, if any, should be required?
- What, if any, tasks should paralegals be authorized to perform?
- Do paralegals need their own ethics?



American Bar Association (ABA) | Wex | US Law | LII / Legal Information Institute

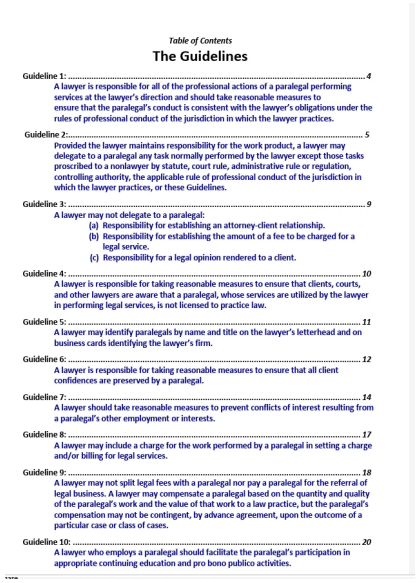


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The Guidelines

Guideline 1: *4*
A lawyer is responsible for all of the professional actions of a paralegal performing services at the lawyer's direction and should take reasonable measures to ensure that the paralegal's conduct is consistent with the lawyer's obligations under the rules of professional conduct of the jurisdiction in which the lawyer practices.

Guideline 2: *5*
Provided the lawyer maintains responsibility for the work product, a lawyer may delegate to a paralegal any task normally performed by the lawyer except those tasks proscribed to a nonlawyer by statute, court rule, administrative rule or regulation, controlling authority, the applicable rule of professional conduct of the jurisdiction in which the lawyer practices, or these Guidelines.

Guideline 3: *9*
A lawyer may not delegate to a paralegal:
(a) Responsibility for establishing an attorney-client relationship.
(b) Responsibility for establishing the amount of a fee to be charged for a legal service.
(c) Responsibility for a legal opinion rendered to a client.

Guideline 4: *10*
A lawyer is responsible for taking reasonable measures to ensure that clients, courts, and other lawyers are aware that a paralegal, whose services are utilized by the lawyer in performing legal services, is not licensed to practice law.

Guideline 5: *11*
A lawyer may identify paralegals by name and title on the lawyer's letterhead and on business cards identifying the lawyer's firm.

Guideline 6: *12*
A lawyer is responsible for taking reasonable measures to ensure that all client confidences are preserved by a paralegal.

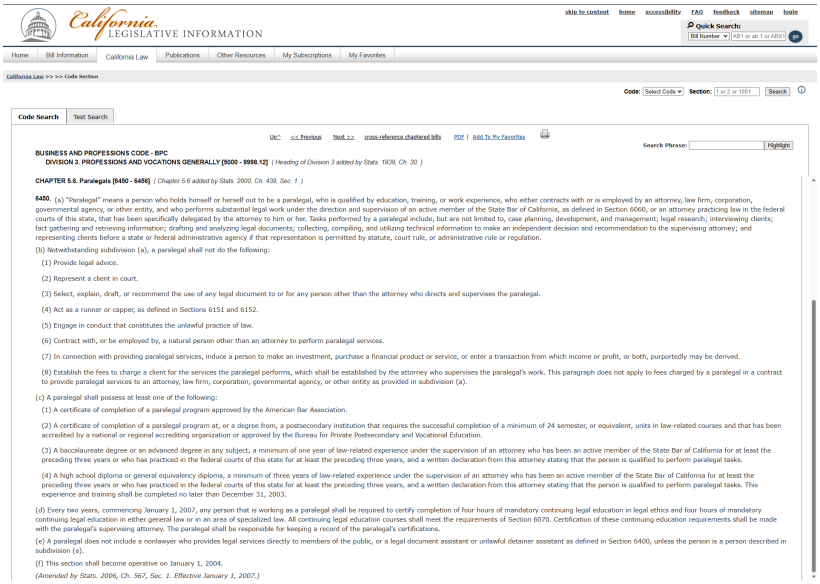
Guideline 7: *14*
A lawyer should take reasonable measures to prevent conflicts of interest resulting from a paralegal's other employment or interests.

Guideline 8: *17*
A lawyer may include a charge for the work performed by a paralegal in setting a charge and/or billing for legal services.

Guideline 9: *18*
A lawyer may not split legal fees with a paralegal nor pay a paralegal for the referral of legal business. A lawyer may compensate a paralegal based on the quantity and quality of the paralegal's work and the value of that work to a law practice, but the paralegal's compensation may not be contingent, by advance agreement, upon the outcome of a particular case or class of cases.

Guideline 10: *20*
A lawyer who employs a paralegal should facilitate the paralegal's participation in appropriate continuing education and pro bono publico activities.

California regulates paralegals under [the Business and Professions Code](#).



California. LEGISLATIVE INFORMATION

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BUSINESS AND PROFESSIONS CODE - BPC
DIVISION 3. PROFESSIONS AND VOCATIONS GENERALLY [5000 - 9998.12] *(Heading of Division 3 added by Stats. 1939. Ch. 30.)*

CHAPTER 5.6. Paralegals [6450 - 6456] *(Chapter 5.6 added by Stats. 2000, Ch. 439, Sec. 1.)*

6450. (a) "Paralegal" means a person who holds himself or herself out to be a paralegal, who is qualified by education, training, or work experience, who either contracts with or is employed by an attorney, law firm, corporation, governmental agency, or other entity, and who performs substantial legal work under the direction and supervision of an active member of the State Bar of California, as defined in Section 6060, or an attorney practicing law in the federal courts of this state, that has been specifically delegated by the attorney to him or her. Tasks performed by a paralegal include, but are not limited to, case planning, development, and management; legal research; interviewing clients; fact gathering and retrieving information; drafting and analyzing legal documents; collecting, compiling, and utilizing technical information to make an independent decision and recommendation to the supervising attorney; and representing clients before a state or federal administrative agency if that representation is permitted by statute, court rule, or administrative rule or regulation.

(b) Notwithstanding subdivision (a), a paralegal shall not do the following:

(1) Provide legal advice.

(2) Represent a client in court.

(3) Select, explain, draft, or recommend the use of any legal document to or for any person other than the attorney who directs and supervises the paralegal.

(4) Act as a runner or capper, as defined in Sections 6151 and 6152.

(5) Engage in conduct that constitutes the unlawful practice of law.

(6) Contract with, or be employed by, a natural person other than an attorney to perform paralegal services.

(7) In connection with providing paralegal services, induce a person to make an investment, purchase a financial product or service, or enter a transaction from which income or profit, or both, purportedly may be derived.

(8) Establish the fees to charge a client for the services the paralegal performs, which shall be established by the attorney who supervises the paralegal's work. This paragraph does not apply to fees charged by a paralegal in a contract to provide paralegal services to an attorney, law firm, corporation, governmental agency, or other entity as provided in subdivision (a).

(c) A paralegal shall possess at least one of the following:

(1) A certificate of completion of a paralegal program approved by the American Bar Association.

(2) A certificate of completion of a paralegal program at, or a degree from, a postsecondary institution that requires the successful completion of a minimum of 24 semester, or equivalent, units in law-related courses and that has been accredited by a national or regional accrediting organization or approved by the Bureau for Private Postsecondary and Vocational Education.

(3) A baccalaureate degree or an advanced degree in any subject, a minimum of one year of law-related experience under the supervision of an attorney who has been an active member of the State Bar of California for at least the preceding three years or who has practiced in the federal courts of this state for at least the preceding three years, and a written declaration from this attorney stating that the person is qualified to perform paralegal tasks.

(4) A high school diploma or general equivalency diploma, a minimum of three years of law-related experience under the supervision of an attorney who has been an active member of the State Bar of California for at least the preceding three years or who has practiced in the federal courts of this state for at least the preceding three years, and a written declaration from this attorney stating that the person is qualified to perform paralegal tasks. This experience and training shall be completed no later than December 31, 2003.

(d) Every two years, commencing January 1, 2007, any person that is working as a paralegal shall be required to certify completion of four hours of mandatory continuing legal education in legal ethics and four hours of mandatory continuing legal education in either general law or in an area of specialized law. All continuing legal education courses shall meet the requirements of Section 6070. Certification of these continuing education requirements shall be made with the paralegal's supervising attorney. The paralegal shall be responsible for keeping a record of the paralegal's certifications.

(e) A paralegal does not include a nonlawyer who provides legal services directly to members of the public, or a legal document assistant or unlawful detainer assistant as defined in Section 6400, unless the person is a person described in subdivision (a).

(f) This section shall become operative on January 1, 2004.

(Amended by Stats. 2006, Ch. 567, Sec. 1. Effective January 1, 2007.)

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2: PARALEGAL WORKPLACE

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2.2: Law firm organization
2.3: Conflicts checks
2.4: The finances of law
2.5: Government work
2.6: Paralegal tasks
2.7: In-House Counsel
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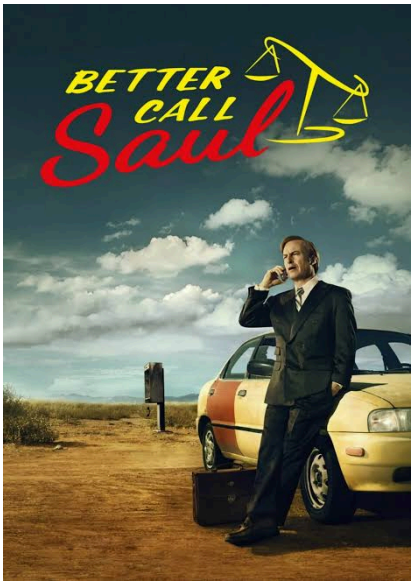
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2.1: Law firms as a workplace

Introduction to the Paralegal Workplace: Law firm edition

The paralegal profession grew out of lawyers needing help with cases and transactional work. Not all attorneys could afford to hire a junior attorney to help. Many relied on legal secretaries and law clerks to help with case preparation. Over the years the support staff became very skilled in those activities and the idea of billing clients for that work grew. Clients did not want to pay the lawyers hourly rate. They wanted a more affordable hourly rate for activities that were considered support such as client letters, propounding discovery, and investigating claims. The paralegal profession can differ depending on the type of law practice, size of the law firm, and the experience of the paralegal.

This chapter covers the law firm structure. The arrangements and organization of law offices can give context to the ethical, financial, and organization similarities and differences between legal organizations who serve legal consumers.



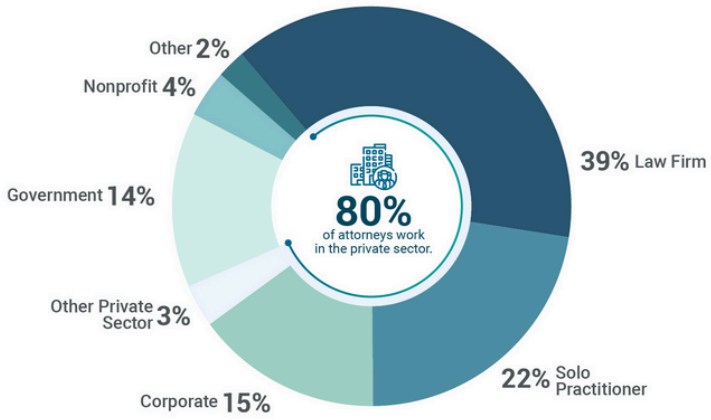
Solo Practice

The solo practitioner describes a lawyer who serves legal clients without additional attorneys. The paralegal in this type of law practice will do work that would be assigned to a junior associate in a larger firm. That might sound exciting but paralegals must always be in a position to say they do not have adequate background to perform a task. Not all solo practitioners will have time to train the paralegal.

Solo practice firms will also not have accounting and human resources departments. The paralegal may serve as the office manager handling collections and bill paying for the attorney. The paralegal will also be very involved in client management and communication as the intermediary with the attorney.

22% of all attorneys are solo practitioners in California. Most solo practitioners will handle matters in multiple practice areas in order to be profitable. They serve the clients in the community where their office is located. The community might be suburban or urban. There might be mostly families or mostly business clients. There will be a variety of clients but the matters or problems they bring do not require more than 1 attorney. These lawyers typically have a general practice with the lawyer knowledgeable in many different areas of law that impact families, individuals, and small businesses. Complex legal matters require multiple attorneys and paralegals. . .

Figure 13. California Attorneys' Primary Employment Sector



https://publications.calbar.ca.gov/2022-diversity-report-card/where-attorneys-work

Sometimes sole practitioners set up offices near one another and share resources. For example, they might share a receptionist and paralegal. They are each independent. Depending on the agreements or arrangements, the lawyers may refer clients to one another.

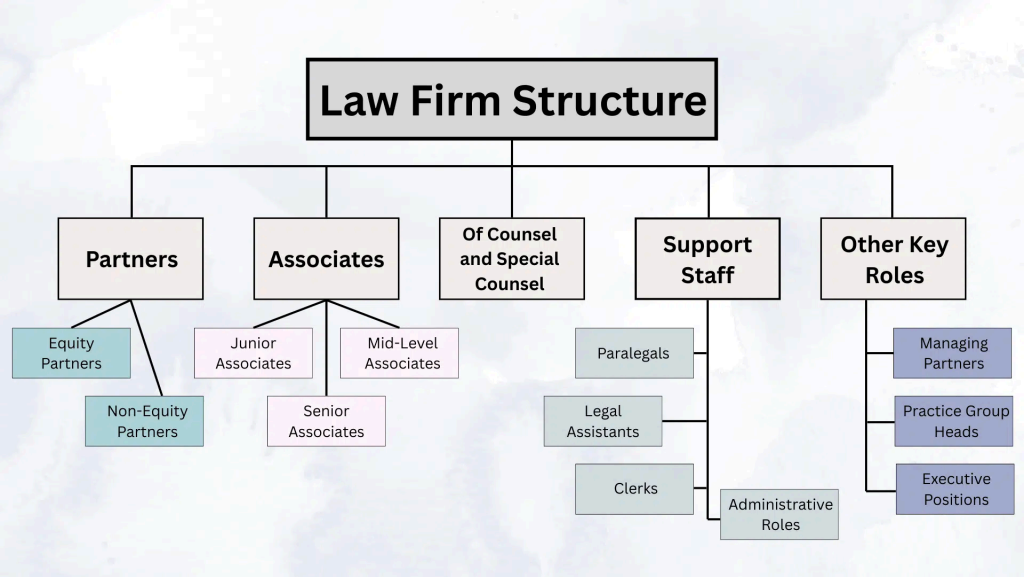
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2.2: Law firm organization

Partnerships

A partnership is an arrangement between two or more persons who agree to share responsibilities and profits of a business. This type or organization may have attorneys and associates. Associates are not partners. They are usually newer attorneys seeking experience and future partnership.

With a partnership the paralegal may work for multiple attorneys once again. This can create problems if attorneys are demanding work be completed within the same timeframe. The common organization in many partnerships is for one attorney to be the primary partner. This makes the paralegals' job clear when they need to prioritize work given to them. Whatever the arrangement the paralegal and attorney are subject to confidentiality and other ethical obligations.



Large Offices

Many large legal offices grew from smaller offices joining and adding more partners and junior associates. Larger firms developed in large cities growing profits and expanding to other states and cities. Presence in other regions opened up new practice areas. Eventually firms grew large enough to open offices in other countries.The large law firms began to act more like corporations while remaining a partnership with potentially hundreds of partners.

The large law firm is an opportunity for the paralegal to work on complex legal matters like mergers and acquisitions and sophisticated litigation. Clients benefit from law firms with many offices. A large manufacturer may need legal advice in corporate law, environmental law, and intellectual property. The larger law firm may have attorneys who practice in all these areas.

Unlike the small law firm where the paralegal may be the bookkeeper and office manager, the larger firm will have a larger support staff. The larger firm may have an entire department that manages duplication and mail for example.

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2.3: Conflicts checks

Administrative Procedures in law offices

Conflicts Checking

Conflict checking is necessary to verify that a new client or matter will not create a conflict of interest with current or previous client matters. This also includes other parties to a matter not directly served but involved in a transaction like drafting a contract or a marital dissolution. A conflict arises when attorneys or paralegals have previously worked on a client matter. They will have confidential information that creates a conflict if put in a position now adverse to that same client.

Today many firms use databases for conflict checking where the names of clients, opposing parties, counsel, and law firms can be easily searched. Determining conflicts can be difficult where there has only been indirect representation. A conflict check isn't just about matching names. It requires looking at the *role*s of the parties (plaintiff, defendant, witness, affiliate) and understanding the *relationship*s between the matters.

Here are some examples of conflicts.

Conflict 1

A new client, MegaCorp, wants to retain your firm to sue TechStart for patent infringement.

Your firm's corporate department currently represents TechStart in an ongoing round of venture capital financing.

This is a concurrent client conflict. A law firm cannot represent Client A in a lawsuit against Client B if the firm currently represents Client B in *any* capacity, even if the two matters are completely unrelated. It violates the absolute duty of loyalty.

Conflict 2

A medical malpractice victim wants to hire your firm to sue Dr. Sagawa. Your firm runs a check and finds no record of Dr. Sagawa. A partner who just joined your firm last month from a rival firm used to personally defend Dr. Sagawa in malpractice suits at her old job.

Under legal ethics rules, a conflict held by one attorney is generally *imputed* (implicates) to the entire firm—meaning if one person can't take the case, the whole firm is impacted. To fix this, firms sometimes have to build a timely and effective ethical wall (or screening mechanism) to isolate that new partner from the case.

Conflict 3

A local environmental group wants to hire your firm to block the construction of a new chemical plant because it borders a local river. The lead environmental litigation partner at your firm happens to be a major shareholder in the energy company building the plant.

This is a personal interest conflict. Attorneys cannot take on a matter if their own financial, personal, or political beliefs could materially limit their ability to advocate zealously for the client. Even if the firm as a whole doesn't have a client conflict, the individual lawyer's ties create an ethical roadblock.

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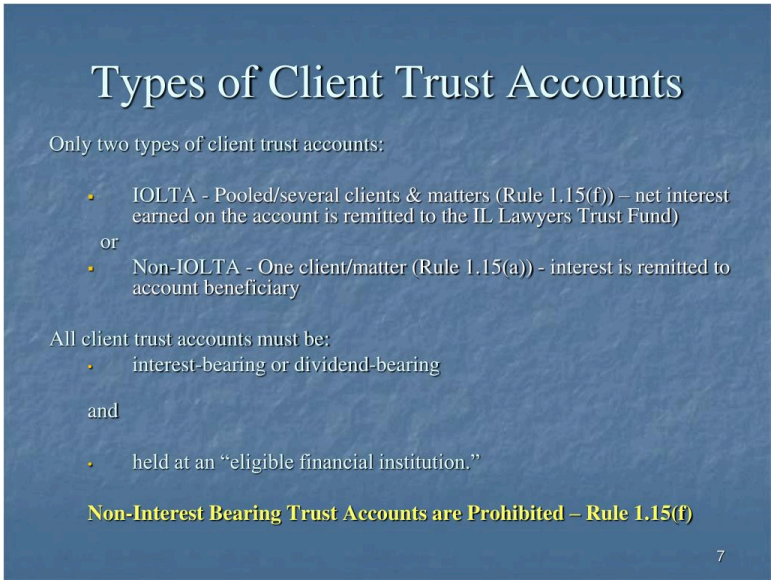
2.4: The finances of law

Law Firm Financial Information

Like any other business law firms have financial duties and responsibilities. They must pay their own bills and payroll. But they also handle client funds. They often take retainers or a determined amount of money when they agree to take on a client matter. Activities undertaken by attorneys and paralegals will be billed against that retainer.

Records must be kept of billing and disbursements. Segregation of client funds from those of the law firm is an important obligation under Rule 1.15 of the Model Rules of Professional Conduct and the ethical rules of each state bar.

A trust account or fiduciary account contains the client funds and can never be commingled with those of the firm or individual attorney. Trust transaction records must be maintained and produced upon inspection by the state bar. Many trust and estate accounts are invested to earn interest while the money is in safekeeping.



The repealed prior version of this rule that was effective from November 1, 2018 to December 31, 2022, and the Executive Summary concerning those amendments can be found here.

Rule 1.15 Safekeeping Funds and Property of Clients and Other Persons (Rule Approved by the Supreme Court, Effective January 1, 2023)

(a) All funds received or held by a lawyer or law firm* for the benefit of a client, or other person* to whom the lawyer owes a contractual, statutory, or other legal duty, including advances for fees, costs and expenses, shall be deposited in one or more identifiable bank accounts labeled "Trust Account" or words of similar import, maintained in the State of California, or, with written* consent of the client, in any other jurisdiction where there is a substantial* relationship between the client or the client's business and the other jurisdiction.

(b) Notwithstanding paragraph (a), a flat fee paid in advance for legal services may be deposited in a lawyer's or law firm's operating account, provided:

(1) the lawyer or law firm* discloses to the client in writing* (i) that the client has a right under paragraph (a) to require that the flat fee be deposited in an identified trust account until the fee is earned, and (ii) that the client is entitled to a refund of any amount of the fee that has not been earned in the event the representation is terminated or the services for which the fee has been paid are not completed; and

(2) if the flat fee exceeds $1,000.00, the client's agreement to deposit the flat fee in the lawyer's operating account and the disclosures required by paragraph (b)(1) are set forth in a writing* signed by the client.

(c) Funds belonging to the lawyer or the law firm* shall not be deposited or otherwise commingled with funds held in a trust account except:

(1) funds reasonably* sufficient to pay bank charges; and

(2) funds belonging in part to a client or other person* and in part presently or potentially to the lawyer or the law firm,* in which case the portion belonging to the lawyer or law firm* must be withdrawn at the earliest reasonable* time after the lawyer or law firm's interest in that portion becomes fixed. However, if a client or other person* disputes the lawyer or law firm's right to receive a portion of trust funds, the disputed portion shall not be withdrawn until the dispute is finally resolved.

(d) A lawyer shall:

(1) absent good cause, notify a client or other person* no later than 14 days of the receipt of funds, securities, or other property in which the lawyer knows* or reasonably should know* the client or other person* has an interest;

(2) identify and label securities and properties of a client or other person* promptly upon receipt and place them in a safe deposit box or other place of safekeeping as soon as practicable;

(3) maintain complete records of all funds, securities, and other property of a client or other person* coming into the possession of the lawyer or law firm;*

(4) promptly account in writing* to the client or other person* for whom the lawyer holds funds or property;

(5) preserve records of all funds and property held by a lawyer or law firm* under this rule for a period of no less than five years after final appropriate distribution of such funds or property;

(6) comply with any order for an audit of such records issued pursuant to the Rules of Procedure of the State Bar; and

(7) promptly distribute any undisputed funds or property in the possession of the lawyer or law firm* that the client or other person* is entitled to receive.

(e) The Board of Trustees of the State Bar shall have the authority to formulate and adopt standards as to what "records" shall be maintained by lawyers and law firms* in accordance with subparagraph (d)(3). The standards formulated and adopted by the Board, as from time to time amended, shall be effective and binding on all lawyers.

(f) For purposes of determining a lawyer's compliance with paragraph (d)(7), unless the lawyer, and the client or other person* agree in writing that the funds or property will continue to be held by the lawyer, there shall be a rebuttable presumption affecting the burden of proof as defined in Evidence Code sections 605 and 606 that a violation of paragraph (d)(7) has occurred if the lawyer, absent good cause, fails to distribute undisputed funds or property within 45 days of the date when the funds become undisputed as defined by paragraph (g). This presumption may be rebutted by proof by a preponderance of evidence that there was good cause for not distributing funds within 45 days of the date when the funds or property became undisputed as defined in paragraph (g).

(g) As used in this rule, "undisputed funds or property" refers to funds or property, or a portion of any such funds or property, in the possession of a lawyer or law firm* where the lawyer knows* or reasonably should know* that the ownership interest of the client or other person* in the funds or property, or any portion thereof, has become fixed and there are no unresolved disputes as to the client's or other person's* entitlement to receive the funds or property.

Standards:

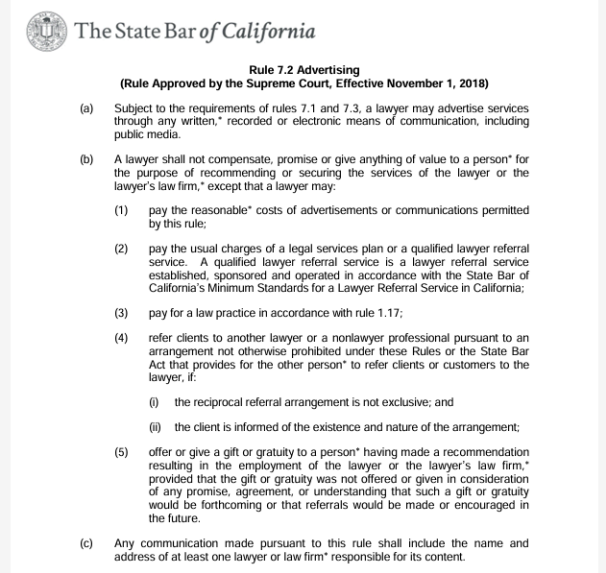
Pursuant to this rule, the Board of Trustees of the State Bar adopted the following standards, effective November 1, 2018, as to what "records" shall be maintained by lawyers and law firms* in accordance with paragraph (d)(3).

(1) A lawyer shall, from the date of receipt of funds of the client or other person* through the period ending five years from the date of appropriate disbursement of such funds, maintain:



Bringing in business

The business of law is serving clients. Finding clients requires skills not taught in law school. Lawyers must learn how to find new clients looking for legal services and they must do so in compliance with ethical rules around advertising.



The State Bar of California

Rule 7.2 Advertising
(Rule Approved by the Supreme Court, Effective November 1, 2018)

(a) Subject to the requirements of rules 7.1 and 7.3, a lawyer may advertise services through any written,* recorded or electronic means of communication, including public media.

(b) A lawyer shall not compensate, promise or give anything of value to a person* for the purpose of recommending or securing the services of the lawyer or the lawyer's law firm,* except that a lawyer may:

(1) pay the reasonable* costs of advertisements or communications permitted by this rule;

(2) pay the usual charges of a legal services plan or a qualified lawyer referral service. A qualified lawyer referral service is a lawyer referral service established, sponsored and operated in accordance with the State Bar of California's Minimum Standards for a Lawyer Referral Service in California;

(3) pay for a law practice in accordance with rule 1.17;

(4) refer clients to another lawyer or a nonlawyer professional pursuant to an arrangement not otherwise prohibited under these Rules or the State Bar Act that provides for the other person* to refer clients or customers to the lawyer, if:

(i) the reciprocal referral arrangement is not exclusive; and

(ii) the client is informed of the existence and nature of the arrangement;

(5) offer or give a gift or gratuity to a person* having made a recommendation resulting in the employment of the lawyer or the lawyer's law firm,* provided that the gift or gratuity was not offered or given in consideration of any promise, agreement, or understanding that such a gift or gratuity would be forthcoming or that referrals would be made or encouraged in the future.

(c) Any communication made pursuant to this rule shall include the name and address of at least one lawyer or law firm* responsible for its content.

Rule_7.2-Exec_Summary-Redline.pdf

New rules around lawyer advertising became effective in January 2026., SB 37

The primary concerns are misleading or fraudulent claims by attorneys. Statements made by attorneys that report past results are restricted, as they can possibly create an expectation of success for new or future clients. An express guarantee or warranty regarding the result of a particular case is prohibited because no one can ensure a legal outcome. Testimonials and endorsements, even if factually accurate, can be misleading if they give the impression that similar results are achievable in other cases. An attorney must explain to clients the unique circumstances of each matter.

Watch this video from the State Bar of California

California Rules of Professional Conduct, Rules 7.1–7.3: Attorney Advertising and Solicitation

Lawyers must bring in new clients to be profitable and keep the business going. They must comply with ethics rules regarding advertising. Effective representation and satisfied clients helps firms build a reputation in a community and get referrals. Paralegals are not responsible for bringing in new clients although that may happen. Typically their pay is not tied to that activity. Frequently lawyer pay is tied to the creation of new business.

Client business means work that can be charged to the client. That time is called billable hours. This is time spent conducting legal work. As a condition of employment lawyers must meet the firm's set annual billable hours requirements.

Paralegals bill for work the same as attorneys, except that paralegals are usually billed at a lower rate. Paralegals typically have a lower billable requirement because paralegals may also manage more non-billable administrative duties. Even with lower billable rates and lower billable expectations, paralegals can still be a profit center for a law firm.

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2.5: Government work

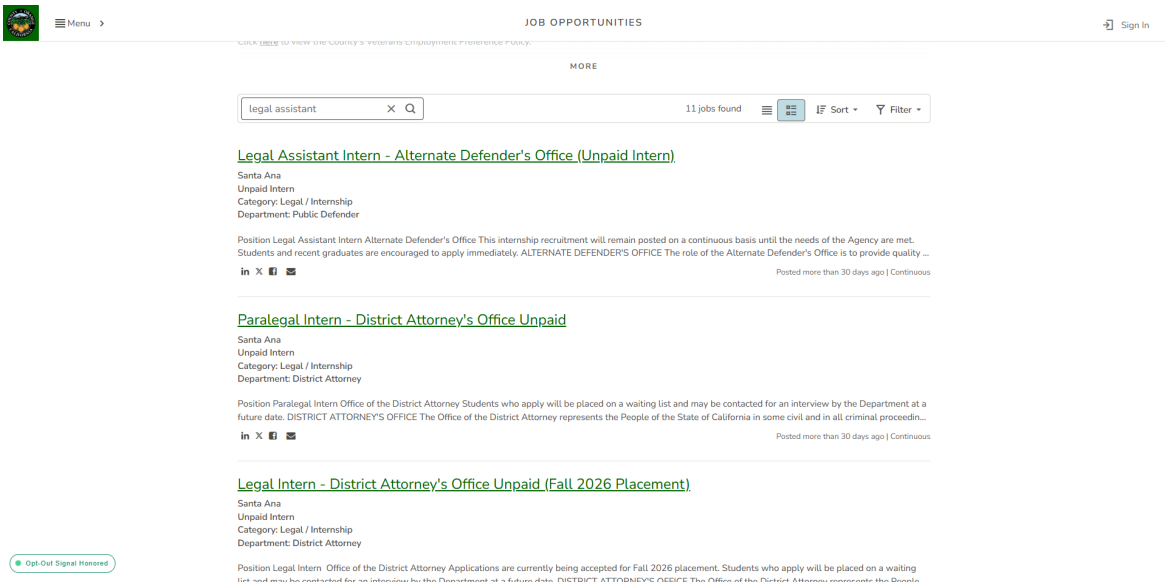


Government Work

City, county, state and federal government work employs many paralegals. They may work in a department that collects child support, supports the district attorney, or works with the public defender. Additionally administrative agencies are governmental and those utilize paralegals.

Obtaining an internship with a county department is an excellent way to explore working as a legal professional in government.

Job Opportunities | Sorted by Relevance ascending | County of Orange Careers



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2.6: Paralegal tasks

Paralegal Tasks

The paralegal is working to support the attorney and serve the client. What support tasks look like will depend on the practice areas and also on the attorney. In many instances the paralegal provides indispensable support for the attorney. Over years of experience the paralegal becomes very familiar with clients and the practice area so the support makes the work of the lawyer efficient and friction free.

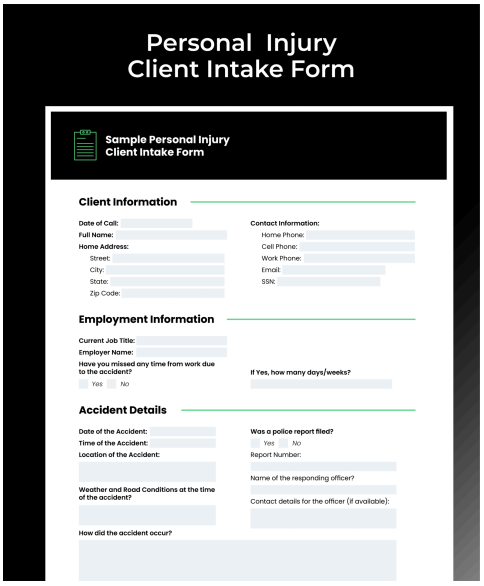
What paralegals do

- ☐ Conduct interviews
- ☐ Manage contracts with clients
- ☐ Organize and maintain client files
- ☐ Prepare pleadings and discovery
- ☐ Maintain calendar and “tickler” (reminder) systems for important dates
- ☐ Conduct research
- ☐

Perform office administrative functions including time keeping and billing records

Client Interviews

Paralegals are frequently the first line of contact with clients. They may need to take notes over the phone. The firm may or may not have case management software and may still have paper client files.



Formatting a California Court Pleading

Review the Sample Pleading

You will learn the procedure for drafting and filing legal pleadings in your Civil Procedure class. For this class, I only want you to focus on how the document is formatted.

Click here to take a moment and look at this sample pleading.Download Click here to take a moment and look at this sample pleading.

Dissecting the Formatting

Now that you have looked at the sample pleading. Let's break it down and discuss how each part is created.

Lined Pleading Paper

California Courts require the use of lined pleading paper for all pleadings filed in the Superior Court. The lines are created as part of the documents Header/Footer section. This is also where you would type the firm name if you wanted the firm name to appear on the side of each page. Pleading paper is a template in Microsoft Word.

Standard Format Requirements

California Rule of Court (CRC) Rule 2.102 states that all court documents must be **single sided on 8.5" x 11" white paper**.

CRC Rule 2.104 states that you must use **12pt font** (14 pt font if you are filing in Federal Courts).

CRC Rule 2.105 dictates the **Font Style** must be either Times New Roman, Courier, or Arial.

CRC Rule 2.107 dictates the pleading to have **1" margins** on all sides.

CRC Rule 2.108(1) dictates the **line spacing** (for the body of the pleading) must be 1.5 (use 2.0 if your are filing in Federal).

CRC Rule 2.110 dictates that all pleadings must have a **footer** centered at the bottom of the page. A **line** must separate the footer from the body of the pleading. The **page number** should be above the footer line. The **document name** should be in the footer and **may** be abbreviated as necessary. The footer font must **not be less than 10pt font**.

image.png

Firm Address and Court Name

The attorney's name goes on line 1. You may list multiple attorneys, but each name must be on its own line. The attorney that is signing the document must be listed here in the firm address. The attorney's bar number is listed in parenthesis right after the name. A licensed attorney is always designated with Esq. after their name. This earned title becomes part of their formal name, like a medical doctor being designated with a Dr. in front of their name.

The law firm name is listed after the attorney's name. It can either be all caps, or word caps, or any style the firm prefers. Most firms like to have the firm name in all caps to stand it apart from the attorney names.

The firm address is next, followed by city, state, and zip code. The firms telephone number, and fax number (fax is not mandatory). It is not mandatory but is very common to see the attorney's email address listed in this section.

The next line is left blank, followed by which party the law firm represents (Plaintiff, Defendant, Respondent, Petitioner, etc.). The last line is the client's name (usually all in caps as a sign of respect to the client).

The Court name NEVER starts above line 8. CRC Rule 2.111 requires the right-hand side of lines 1-7 be left blank for court use. This is where the court will stamp the document once it has been filed (known as the conformed copy). The Caption Box will start on line 12.

image.png

The Caption Box

The caption box is built as an embedded table. This allows you to create different boxes. The first box on the left will contain the names of the parties. A named party is always written in Capital letters. The parties designation (an individual, a corporation, an unknown entity, etc.) is always lowercase and written just after the party name. Plaintiff and Defendant designation is always indented to the middle of the first box. The v. is indented a quarter of the distance.

The right-hand box has the case number (assigned by the court at filing) always in Bold so it is easy to spot and read on the document. 2 spaces below the number is the judge the case is assigned to. This is always in italics as a sign of respect to the judge. A judge is always given the designation Hon. before their name. The department number (or letter) is placed after the judge's name.

The document name is 2 spaces below the judge's name. The document name is ALWAYS in all capital letters and bolded. No punctuation.

As you can see from the screenshot

image.png

Document Continuation Marks

A pleading document page is 28 lines long. To denote that the **document continues onto the next page**, but nothing is written on line 28 of the current page, you place **3 backslashes** on the empty line. **Remember the rule of three! You never type more than 3 slashes, and never put them on more than 3 lines.** Even if there are many open lines, you need not place more slashes

than just the last three lines. If there is only one empty line, you only need one line of 3 slashes. If there are two empty lines, you do two lines of slashes.

image.png

Document Topic Heading

If you are starting the body of the pleading on any page other than the caption page, it is good form to **place the topic of the pleading at the head of that page**. This is usually in all **Capital letters, Underlined,** and always in **Bold**.

Body of the Pleading

If a pleading is **longer than ONE paragraph**, you need to **number your paragraphs**. This is best done using the **auto-numbering feature in Word**. That way, if you need to add a paragraph, your numbers will automatically renumber and you won't have to manually update the number of every paragraph in your pleading. Note: Federal Court rules usually do not require numbered paragraphs. Always know the pleading rules for the Court you are writing for!

Signature Blocks

Signatures are easily created using the **Insert Table feature in Word**. This allows you to create a signature block that looks professional and is also easy to update and move when needed. **Left align the first cell** on the top so your date will be on the Left. The Firm Name is in the top cell on the right. The Firm Name is usually in all Caps and Bold Font. If you **Top Align the top 2 cells**, they will line up nice and neat and look perfectly aligned on the document.

The middle cell on the left is **Right Aligned**. The middle cell on the right has a **cell border** added to the **bottom of the cell**. This creates a signature line for the attorney to place his signature on.

The bottom cell on the right contains the attorney name, the party the attorney represents, and the client name. Remember that named parties are **always in capital letters**. While you are drafting the document, the table grid lines will show (like in the photo below), but they won't appear in the printed document.

image.png

When the document is printed, the grid lines will not be visible except for the middle right cell that has a bottom border.

Including a Proof of Service

In order to include a Proof of Service on the last page of a document, you will need to make a **section break**. This will not only allow your proof to start at the head of a new page, but it will allow you to change the footer of the final page without it effecting the remainder of the document. The section break is added after the signature block on the final page. Each section may have its own page numbering style (how you are able to create roman numerals for the caption and tables pages, as well as delete the page numbers in the proof of service page) and footer title.

After the section break has been added, you may now adjust the Proof of Service footer. You will first need to make certain **"Link to Previous" is unchecked** in the Header & Footer Options menu of the Ribbon. Any changes made to this page's footer while the Link to Previous is still turned on, will result in a change to the footer of the prior section. A Proof of Service footer usually **does not have a page number** at all and also does not contain the title of the document it is attached to. Instead, the Proof of Service footer usually just say, "Proof of Service" in all **capital letters** and **Bold Font**.

image.png

Due process and Service of Process

Legal History of "process"

Due process in its most conservative definition is the continuous action that must be taken to make parties aware of a court

action. England regularly held court sessions against those it saw as challengers to its dominance. These revolutionaries were tried without notice or an opportunity to be present and defend themselves.

There are two Due Process of Law Clauses in the United States Constitution. The first is found in the Fifth Amendment:

No person shall be . . . deprived of life, liberty, or property, without due process of law.
.U.S. Const. amend. XIV, § 1 (emphasis added).

The second Due Process of Law Clause is found in Section One of the Fourteenth Amendment:

No State shall make or enforce any law which shall . . . deprive any person of life, liberty, or property, without due process of law.

.*Int'l Shoe Co. v. Washington, 326 U.S. 310, 316 (1945)* ("[D]ue process requires only that in order to subject a defendant to a judgment in personam, if he be not present within the territory of the forum, he have certain minimum contacts with it such that the maintenance of the suit does not offend 'traditional notions of fair play and substantial justice.'").

The conventional wisdom is that the Fifth Amendment applies only to the federal (national) government; the Fourteenth Amendment applies to the states. SCOTUS has interpreted over the decades and centuries that due process applies to all governmental action.

Service of process (an extension of due process)

How service of process occurs depends on the rules of the court or jurisdiction in which the lawsuit is brought. Under FRCP 4(c)(2), service of process in federal court cases may be effected "by any person who is not a party and who is at least 18 years of age." A paralegal, for example, could serve the summons by personally delivering it to the defendant(s).

Alternatively, a person could make arrangements for someone else to do so, subject to the approval of the supervising attorney. Many law firms contract with independent companies that provide process service in the local area. In some cases, the attorney might request that the court have a U.S. marshal or other federal official serve the summons. Under FRCP 4(e)(1), service of process in federal court cases may also be effected "pursuant to the law of the state in which the district court is located." Some state courts require the complaint and summons to be served by a public officer, such as a sheriff.

Although the most common way to serve process on a defendant is through personal service, or actual delivery, as described previously, other methods are permissible at times, depending on the jurisdiction. Substituted service is any method of service allowed by law in place of personal service, such as service by certified mail, fax, or e-mail. Most states allow a process server to effect service by leaving a copy of the documents at the defendant's place of work, at his or her home address, or with someone else who resides in the home (such as a wife or an older child). In some circumstances, if the defendant cannot be physically located, the law may allow the process server to effect service by mailing a copy of the summons and complaint to the defendant's last known address and/or publishing a notice in the local newspaper. In other situations, delivering the documents to an authorized agent is sufficient. The paralegal and attorney thus need to know the types of service authorized by the laws of civil procedure in their own state.

In cases involving corporate defendants, the summons and complaint may be served on an officer or a registered agent (representative) of the corporation. The name of a corporation's registered agent and its business address can usually be obtained from the secretary of state's office in the state in which the company incorporated its business (and, usually, the secretary of state's office in any state in which the corporation does business).

See The Original Meaning of "Due Process of Law" in the Fifth Amendment - Virginia Law ReviewLinks to an external site.

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2.7: In-House Counsel



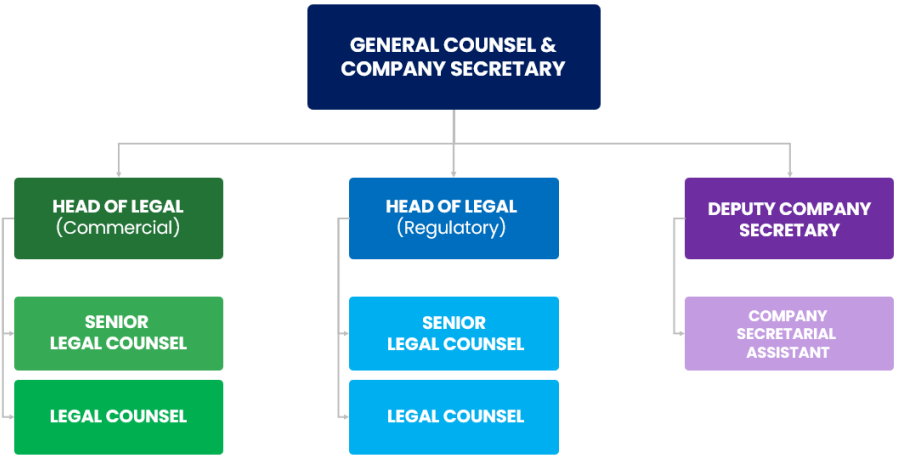
In house counsel

The legal department within a corporation is responsible for all legal matters that concern the business. It may form subsidiaries which involve state corporate law. It will respond to lawsuits. And that may mean they outsource work to a litigation firm. They may also deal with products that are defective or internal employee legal matters. There will be an attorney who is called the General Counsel and one or more paralegals.

Unlike external attorneys who serve different clients, the primary obligation of an in-house attorney is to a single employer. This permits them to develop a deep understanding of the organization's operations, culture, and strategic goals. Having an internal legal department is critical for ensuring that the organization's business practices adhere to all applicable laws and regulations, which mitigates legal risks and enhances compliance.

Corporations do not always have an in-house legal department. They can outsource all legal work to a law firm.

	In-House Counsel	Outside General Counsel	Legacy Law Firms
Hourly rates	LOW	MODERATE	HIGH
Per-hour efficiency	MODERATE	HIGH	LOW
Understanding of client business and operations	HIGH	MODERATE	LOW
Attorney turnover	LOW	LOW	HIGH
Capacity for large matters	LOW	MODERATE	HIGH



Structure of an in-house legal department

Common Responsibilities of In-House Counsel

Contract Management: A significant portion of an in-house lawyer's time is dedicated to contracts. This involves drafting new agreements, reviewing contracts from vendors or partners, and negotiating terms to protect the company's interests. They handle documents, including sales agreements, service agreements, non-disclosure agreements, and real estate leases.

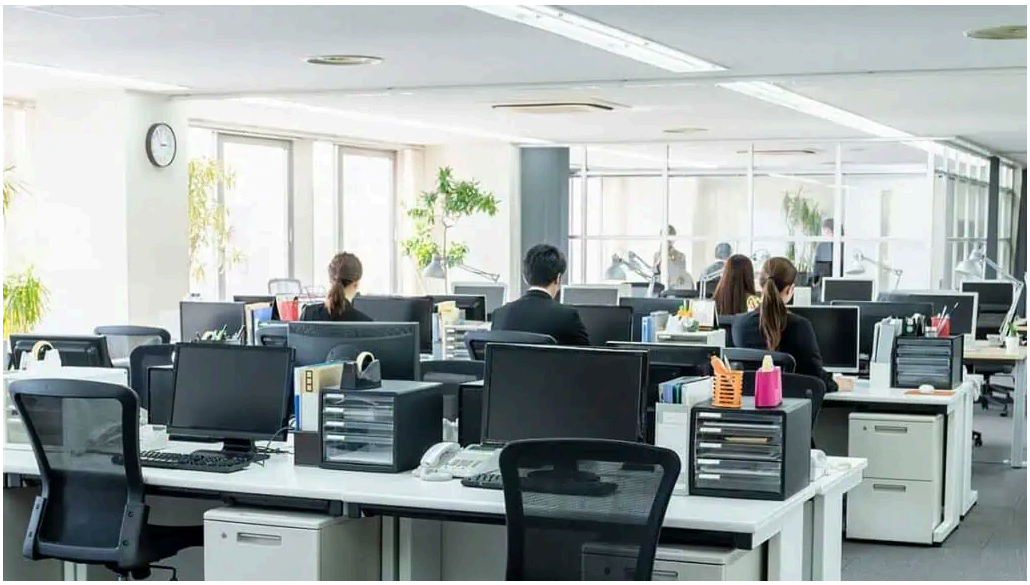
Corporate Governance and Compliance: In-house counsel ensures the company operates ethically and within the bounds of corporate law. They are responsible for creating and implementing compliance programs covering areas like anti-bribery laws, data privacy regulations, and industry-specific rules. This involves keeping up with changing legislation, training employees on legal requirements, and investigating potential compliance breaches.

Litigation Management: While companies hire outside law firms for litigation, the in-house legal team manages this process. They are responsible for selecting the right external lawyers, defining the legal strategy, and managing the budget for the case. They act as the bridge between company executives and trial attorneys, translating business needs into legal action and legal complexities into business implications.

Employment and Labor Law: In-house lawyers provide advice to the human resources department on a variety of employment-related issues such as hiring practices, employee discipline, and termination procedures to ensure they comply with labor laws. They also help draft employment contracts, and develop internal policies for employee handbooks.

Intellectual Property: For some companies, intellectual property (IP) is a valuable asset. IP rights include trademarks, patents, and copyrights. Their responsibilities might involve filing for trademark protection, managing the company's patent portfolio, or drafting licensing agreements that allow other parties to use the company's IP.

Mergers and Acquisitions (M&A): When a company decides to buy, sell, or merge with another business, in-house lawyers are deeply involved. They conduct due diligence, which is the process of investigating the target company's legal and financial health to identify potential risks. They also help structure the deal, negotiate the terms of the acquisition agreement, and manage the integration of the two companies.



Law office spaces are sometimes hierarchical. Senior partners will have private offices. Junior associates may or may not share an office. Paralegals and support staff will be in more open spaces to allow for accessibility.

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2.8: efiling in the Courts

Introduction to Electronic Filing

Electronic Court Filing (e-Filing)

Electronic court filing (ECF), or e-filing, is the automated transmission of legal documents from an attorney, party or self-represented litigant to a court, from a court to an attorney, and from an attorney or other user to another attorney or other user of legal documents.

All Federal Courts require case pleadings to be filed electronically. You may explore more about electronic filing by visiting the United States Courts CM/ECF websiteLinks to an external site..

THE E-FILING PROCESS: AN OVERVIEW

Simply put, it entails sending documents to a court's computer system via a secure file transfer. If you're undertaking legal action, filing something new for an ongoing matter, or reopening a previously closed case in a jurisdiction that either allows or requires parties to electronically submit documents or pleadings then you are e-filing.

To e-file, you'll need to make sure you have all the necessary documents converted into the required document type – most often a PDF – and that you have access to all the necessary websites.

Note: some state courts only allow lawyers or county clerks to e-file and you might need to register with the court to complete the process.

TERMS TO KNOW

DOTS PER INCH (DPI)

DPI refer to the quality of a scanned image or document. This term comes from the printing industry and refers to how many printer dots are in a square printed inch. Courts usually require a minimum of 300dpi for a printed document to be readable.

Electronic Filing Service Provider (EFSP)

The EFSP is how you upload and deliver documents to a court's computer system using a secure file transfer. This online service serves as the go-between for you and the court system.

ELECTRONIC FILING MANAGER (EFM)

An EFM is the software used on the court's side to intake and process documents for courthouse clerks to access. Once your filing has been accepted, your documents are put into the Case Management System (CMS) – another term that's good to know – and become a permanent part of the court record.

FILING PARTY

Filing party refers to the individual(s) who bring or respond to a lawsuit in court. You may also see reference to "Party type." "Party type" is the role of each party in the case – i.e., defendant, plaintiff, etc.

FILING QUEUE STATUS

Indicates where your e-filing is in the process. Terms may vary by software, but may include "Draft," "Submitted," "Under review," "Accepted," "Rejected."

LEAD DOCUMENT

A lead document is any document you need the court to look at. When received by the court, a lead document will include its own timestamp. If lead documents are combined into one single document, the e-filing may be rejected. You can file more than one lead document for a case, but they shouldn't be combined into one PDF. However, lead documents can include attachments as reference.

NOTICE OF ELECTRONIC FILING (NEF)

Notice of Electronic Filing is the notice generated when a document is submitted and transmitted through an e-filing system. This system generates the time of transmission, name of court, party transmitting document, document title and type, and the name of the recipient. An NEF is automatically delivered to the individual who submits the documents.

OPTICAL CHARACTER RECOGNITION (OCR)

Optical Character Recognition (OCR) enables the conversion of scanned documents to be editable and searchable data. The use of OCR in submitted documents may cause the submission to fail. The best practice is to not apply OCR to documents submitted in eFS.

REFERENCE NUMBER

An internal reference number the eFiler gives a filing

e-Filing resources

image.png

Before electronic filing of a lawsuit was allowed, the attorney filing a complaint personally delivered the complaint to the clerk of the court, together with a specified number of copies of the complaint and a check payable to the court in the amount of the required filing fee.

image.png

The court clerk filed the complaint by stamping the date on the first page of all of the documents (original and copies); assigning the case a file number, or docket number; and assigning the case to a particular judge. (In some state courts, the file number or judge may not be assigned until later.) The clerk then returned the date-stamped copies to the person who delivered the documents for service on the defendant.

The Federal Rules of Civil ProcedureLinks to an external site. provide that federal courts may permit filing by electronic means that are consistent with any technical standards established by the Judicial Conference, which sets policy for the administration of the federal courts. E-filing systems are now used in almost all federal courts.

image.png

Public Access to Court Electronic RecordsLinks to an external site. (PACER) is the federal court's e-filing system. With e-filing, registered attorneys can file case documents twenty-four/7, right up to the filing deadline, with no additional filing fees. State and local courts also have rules around the required use of e-filing systems.

The security of the e-filing process is important. Only registered parties may access a court's e-filing system. As with most secure electronic communications, the registered party has a user ID and a password. An attorney may give a paralegal authority to use the system on his or her behalf. Consent of the parties to use e-filing may be required.

Once parties agree to e-filing, the court assigns a docket number to the case. From that point forward, all documents filed and served by consenting parties must use the system. Often, documents must be formatted as PDF (Portable Document Format) files so they cannot be altered. The parties must provide e-mail addresses for notification of service of documents.

A party to an action being handled by e-filing may have the right to request hard copies of documents. When hard copies are used, they are to include a clear notice that they have been filed electronically. Special steps are taken to protect private information, such as Social Security numbers, credit-card information, a minor child's name, or trade secrets.

Fees for documents filed are paid electronically. Therefore, in many cases, all paperwork and communications between the parties and the court may be electronic.

ORANGE COUNTY e-filing

One Legal is a litigation service company. Law firms use them to support a litigation.

One Legal charges for these serviceLinks to an external site.s.

Here is some e-filing training. e-filing trainingLinks to an external site..

HERE is an Orange County Superior Court e=filing resourceLinks to an external site. as well.

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3: INTRODUCTION TO LAW AND LEGAL SYSTEMS

3.1: What Is Law?

3.2: Schools of Legal Thought

3.3: Basic Concepts and Categories of US Positive Law

3.4: Sources of Law and Their Priority

3.5: Legal and Political Systems of the World

3.6: A Sample Case

3.7: Summary and Exercises

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3.1: What Is Law?

Learning Objectives

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

Law 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." [1]

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. In Iraq and Afghanistan, the effective blending of different groups of families, tribes, sects, and ethnic groups into a national governing body that shares power remains to be seen.

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 fifteen 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 fifty 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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3.2: Schools of Legal Thought

Learning Objectives

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

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.

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." [1]

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

The Unanimous Declaration of the Thirteen United States of America

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." [2]

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 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. The “Crits” believe that the social order (and the law) is dominated by those with power, wealth, and influence. Some Crits are clearly influenced by the economist Karl Marx and also by distributive justice theory (see Chapter 2 "Corporate Social Responsibility and Business Ethics"). 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 worked hard under Hitler’s government during World War II to round up Jewish people for incarceration—and eventual extermination—at labor camps like Auschwitz and Buchenwald. After an Israeli “extraction team” took him from Argentina to Israel, he was put on trial for “crimes against humanity.” His defense was that he was “just following orders.” Explain why Eichmann was not an adherent of the natural-law school of legal thought.

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3.3: Basic Concepts and Categories of US Positive Law

Learning Objectives

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

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

Law: The Moral Minimums in a Democratic Society

The law does not 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 "Criminal Law") but also torts (see Chapter 7 "Introduction to Tort Law") and broken promises (see Chapter 8 "Introduction to Contract Law"). 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. 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 eighty 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) 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 "Introduction to Tort Law").

Some of the basic differences between **civil law** and **criminal law** cases are illustrated in Table 1.1 "Differences between Civil and Criminal Cases".

Table 1.1 Differences between Civil and Criminal Cases

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

Regarding plaintiffs and prosecutors, you can often tell a civil case from a criminal case by looking at the caption of a case going to trial. If the government appears first in the caption of the case (e.g., *U.S. v. Lieberman*, it is likely that the United States is prosecuting on behalf of the people. The same is true of cases prosecuted by state district attorneys (e.g., State v. Seidel). But this is not a foolproof formula.

Governments will also bring civil actions to collect debts from or settle disputes with individuals, corporations, or other governments. Thus *U.S. v. Mayer* might be a collection action for unpaid taxes, or *U.S. v. Canada* might be a boundary dispute in the International Court of Justice. Governments can be sued, as well; people occasionally sue their state or federal government, but they can only get a trial if the government waives its sovereign immunity and allows such suits. *Warner v. U.S.*, for example, could be a claim for a tax refund wrongfully withheld or for damage caused to the Warner residence by a sonic boom from a US Air Force jet flying overhead.

Substance versus Procedure

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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3.4: Sources of Law and Their Priority

Learning Objectives

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

Sources of Law

In the United States 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. 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." [1]

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 to be antidemocratic. The House of Representatives, on the other hand, is directly proportioned by population, though no state can have less than one representative.

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. The code is available online at http://uscode.house.gov.

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 "Administrative Law"). 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 "Administrative Law").

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 atwww.access.gpo.gov/nara/cfr...le-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 unusual laws that are in the news from time to time are local ordinances. For example, in Logan County, Colorado, it is illegal to kiss a sleeping woman; in Indianapolis, Indiana, and Eureka, Nebraska, it is a crime to kiss if you have a mustache. But reportedly, some states still have odd laws here and there. Kentucky law proclaims that every person in the state must take a bath at least once a year, and failure to do so is illegal.

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 "Introduction to Tort Law", 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 bride or groom 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 "Administrative Law"), 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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3.5: Legal and Political Systems of the World

Learning Objective

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

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

Comparing Common-Law Systems with Other Legal Systems

The common-law tradition is unique to England, the United States, and 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 religion-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, and adhere to precedent. Civil-law systems decide cases without a jury, often use three judges, and often render shorter opinions without reference to previously decided cases.

EXERCISE

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

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3.6: A Sample Case

Preliminary Note to Students

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

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

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

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

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

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

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

Harris v. Forklift Systems

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

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

JUSTICE O'CONNOR delivered the opinion of the Court.

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

I

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

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

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

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

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

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

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

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

II

Title VII of the Civil Rights Act of 1964 makes it "an unlawful employment practice for an employer...to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin." 42 U.S.C. § 2000e2(a)(1). As we made clear in Meritor Savings Bank, FSB v. Vinson, 477 U.S. 57 (1986), this language "is not limited to 'economic' or 'tangible' discrimination. The phrase 'terms, conditions, or privileges of employment' evinces a congressional intent 'to strike at the entire spectrum of disparate treatment of men and women' in employment," which includes requiring people to work in a discriminatorily hostile or abusive environment. Id., at 64, quoting Los Angeles Dept. of Water and Power v. Manhart, 435 U.S. 702, 707, n.13, 55 L. Ed. 2d 657, 98 S. Ct. 1370 (1978). When the workplace is permeated with "discriminatory intimidation, ridicule, and insult," 477 U.S. at 65, that is "sufficiently severe or pervasive to alter the conditions of the victim's employment and create an abusive working environment," Title VII is violated.

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

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

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

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

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

III

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

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

So ordered.

note to students

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

CASE QUESTIONS

1. Is this a criminal case or a civil-law case? How can you tell?

2. Is the court concerned with making a procedural rule here, or is the court making a statement about the substantive law?

3. Is this a case where the court is interpreting the Constitution, a federal statute, a state statute, or the common law?

4. In Harris v. Forklift, what if the trial judge does not personally agree that women should have any rights to equal treatment in the workplace? Why shouldn't that judge dismiss the case even before trial? Or should the judge dismiss the case after giving the female plaintiff her day in court?

5. What was the employer's argument in this case? Do you agree or disagree with it? What if those who legislated Title VII gave no thought to the question of seriousness of injury at all?

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3.7: Summary and Exercises

Summary

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

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

EXERCISES

1. What is the common law? Where do the courts get the authority to interpret it and to change it?

2. After World War II ended in 1945, there was an international tribunal at Nuremberg that prosecuted various officials in Germany's Third Reich who had committed "crimes against humanity." Many of them claim that they were simply "following orders" of Adolf Hitler and his chief lieutenants. What law, if any, have they violated?

3. What does stare decisis mean, and why is it so basic to common-law legal tradition?

4. In the following situations, which source of law takes priority, and why?

   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.

SELF-TEST QUESTIONS

1. The source of law that is foundational in the US legal system is

a. the common law
b. statutory law
c. constitutional law
d. administrative law

2. "Law is the command of a sovereign" represents what school of legal thought?

a. civil law
b. constitutional law
c. natural law
d. ecofeminist law
e. positive law

3. Which of the following kinds of law are most often found in state law rather than federal law?

a. torts and contracts
b. bankruptcy
c. maritime law

d. international law

4. Where was natural law discovered?

a. in nature
b. in constitutions and statutes
c. in the exercise of human reason
d. in the Wall Street Journal

5. Wolfe is a state court judge in California. In the case of Riddick v. Clouse, which involves a contract dispute, Wolfe must follow precedent. She establishes a logical relationship between the Riddick case and a case decided by the California Supreme Court, Zhu v. Patel Enterprises, Inc. She compares the facts of Riddick to the facts in Zhu and to the extent the facts are similar, applies the same rule to reach her decision. This is

a. deductive reasoning
b. faulty reasoning
c. linear reasoning
d. reasoning by analogy

6. Moore is a state court judge in Colorado. In the case of Cassidy v. Seawell, also a contract dispute, there is no Colorado Supreme Court or court of appeals decision that sets forth a rule that could be applied. However, the California case of Zhu v. Patel Enterprises, Inc. is “very close” on the facts and sets forth a rule of law that could be applied to the Cassidy case. What process must Moore follow in considering whether to use the Zhu case as precedent?

a. Moore is free to decide the case any way he wants, but he may not look at decisions and reasons in similar cases from other states.
b. Moore must wait for the Colorado legislature and the governor to pass a law that addresses the issues raised in the Cassidy case.
c. Moore must follow the California case if that is the best precedent.
d. Moore may follow the California case if he believes that it offers the best reasoning for a similar case.

SELF-TEST AnswerS

1. c

2. e

3. a

4. c

5. d

6. d

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4: COURTS AND THE LEGAL PROCESS

4.10: Cases

4.1: Introduction

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

4.3: The Problem of Jurisdiction

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4.10: Cases

Burger King v. Rudzewicz

Burger King Corp. v. Rudzewicz

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

Summary

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

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

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

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

Justice Brennan delivered the opinion of the court.

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

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

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

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

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

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

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

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

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

It is so ordered.

CASE QUESTIONS

1. Why did Burger King sue in Florida rather than in Michigan?

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

Ferlito v. Johnson & Johnson

Ferlito v. Johnson & Johnson Products, Inc.

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

Gadola, J.

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

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

MOTION FOR JUDGMENT NOTWITHSTANDING THE VERDICT

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

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

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

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

To establish a prima facie case that a manufacturer's breach of its duty to warn was a proximate cause of an injury sustained, a plaintiff must present evidence that the product would have been used differently had the proffered warnings been given. [1] [Citations omitted] In the absence of evidence that a warning would have prevented the harm complained of by altering the plaintiff's conduct, the failure to warn cannot be deemed a proximate cause of the plaintiff's injury as a matter of law. [In accordance with procedure in a diversity of citizenship case, such as this one, the court cites Michigan case law as the basis for its legal interpretation.]

...

A manufacturer has a duty "to warn the purchasers or users of its product about dangers associated with intended use." Conversely, a manufacturer has no duty to warn of a danger arising from an unforeseeable misuse of its product. [Citation]

Thus, whether a manufacturer has a duty to warn depends on whether the use of the product and the injury sustained by it are foreseeable. Gootee v. Colt Industries Inc., 712 F.2d 1057, 1065 (6th Cir. 1983); Owens v. Allis-Chalmers Corp., 414 Mich. 413, 425, 326 N.W.2d 372 (1982). Whether a plaintiff's use of a product is foreseeable is a legal question to be resolved by the court. Trotter, supra. Whether the resulting injury is foreseeable is a question of fact for the jury. [2] Thomas v. International Harvester Co., 57 Mich. App. 79, 225 N.W.2d 175 (1974).

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

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

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

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

ORDER

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

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

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

CASE QUESTIONS

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

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

[1] By "prima facie case," the court means a case in which the plaintiff has presented all the basic elements of the cause of action alleged in the complaint. If one or more elements of proof are missing, then the plaintiff has fallen short of establishing a prima facie case, and the case should be dismissed (usually on the basis of a directed verdict).

[2] Note the division of labor here: questions of law are for the judge, while questions of "fact" are for the jury. Here, "foreseeability" is a fact question, while the judge retains authority over questions of law. The division between questions of fact and questions of law is not an easy one, however.

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4.1: Introduction

Learning Objectives

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

1. Describe the two different court systems in the United States, and explain why some cases can be filed in either court system.

2. Explain the importance of subject matter jurisdiction and personal jurisdiction and know the difference between the two.

3. Describe the various stages of a civil action: from pleadings, to discovery, to trial, and to appeals.

4. Describe two alternatives to litigation: mediation and arbitration.

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

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

Robinson v. Audi

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

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

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

Learning Objectives

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

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 "Constitutional Law and US Commerce"). 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 "Sample Conflict-of-Law Principles").

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

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

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

State Court Systems

The vast majority of civil lawsuits in the United States are filed in state courts. Two aspects of civil lawsuits are common to all state courts: trials and appeals. A court exercising a trial function has original jurisdiction—that is, jurisdiction to determine the facts of the case and apply the law to them. A court that hears appeals from the trial court is said to have appellate jurisdiction—it must accept the facts as determined by the trial court and limit its review to the lower court's theory of the applicable law.

Limited Jurisdiction Courts

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

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

General Jurisdiction Courts

All other civil and criminal cases are heard in the general trial courts, or courts of general jurisdiction. These go by a variety of names: superior, circuit, district, or common pleas court (New York calls its general trial court the supreme court). These are the courts in which people seek redress for incidents such as automobile accidents and injuries, or breaches of contract. These state courts also prosecute those accused of murder, rape, robbery, and other serious crimes. The fact finder in these general jurisdiction courts is not a judge, as in the lower courts, but a jury of citizens. Although courts of general jurisdiction can hear all types of cases, in most states more than half involve family matters (divorce, child custody disputes, and the like). A third were commercial cases, and slightly over 10 percent were devoted to car accident cases and other torts (as discussed in Chapter 7 "Introduction to Tort Law").

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

Appellate Courts

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

The last type of appeal within the state courts system is to the highest court, the state supreme court, which is composed of a single panel of between five and nine judges and is usually located in the state capital. (The intermediate appellate courts are usually composed of panels of three judges and are situated in various locations around the state.) In a few states, the highest court goes by a different name: in New York, it is known as the court of appeals. In certain cases, appellants to the highest court in a state have the right to have their appeals heard, but more often the supreme court selects the cases it wishes to hear. For most litigants, the ruling of the state supreme court is final. In a relatively small class of cases—those in which federal constitutional claims are made—appeal to the US Supreme Court to issue a writ of certiorari remains a possibility.

The Federal Court System

District Courts

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

Courts of Appeal

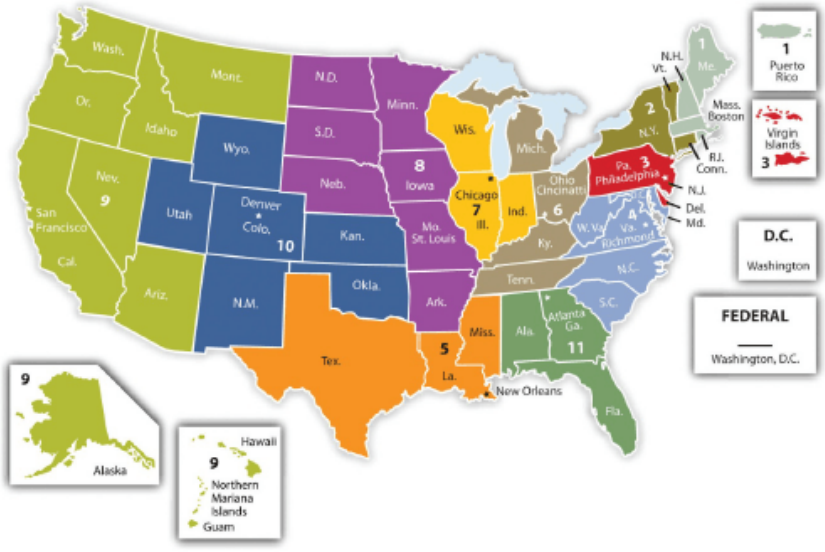
Cases from the district courts can then be appealed to the circuit courts of appeal, of which there are thirteen (Figure 3.1 "The Federal Judicial Circuits"). Each circuit oversees the work of the district courts in several states. For example, the US Court of Appeals for the Second Circuit hears appeals 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 "Administrative Law"). The US Court of Appeals for the Federal Circuit, also located in Washington, hears appeals in patent and customs cases. Appeals are usually heard by three-judge panels, but sometimes there will be a rehearing at the court of appeals level, in which case all judges sit to hear the case “en banc.”

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

United States Supreme Court

Overseeing all federal courts is the US Supreme Court, in Washington, DC. It consists of nine justices—the chief justice and eight associate justices. (This number is not constitutionally required; Congress can establish any number. It has been set at nine since after the Civil War.) The Supreme Court has selective control over most of its docket. By law, the cases it hears represent only a tiny fraction of the cases that are submitted. In 2008, the Supreme Court had numerous petitions (over 7,000, not including thousands of petitions from prisoners) but heard arguments in only 87 cases. The Supreme Court does not sit in panels. All the justices hear and consider each case together, unless a justice has a conflict of interest and must withdraw from hearing the case.

Figure 3.1 *The Federal Judicial Circuits*



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

KEY TAKEAWAY

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

EXERCISES

1. Why all of this complexity? Why don't state courts hear only claims based on state law, and federal courts only federal-law-based claims?

2. Why would a plaintiff in Iowa with a case against a New Jersey defendant prefer to have the case heard in Iowa?

3. James, a New Jersey resident, is sued by Jonah, an Iowa resident. After a trial in which James appears and vigorously defends himself, the Iowa state court awards Jonah $136,750 dollars in damages for his tort claim. In trying to collect from James in New Jersey, Jonah must have the New Jersey court certify the Iowa judgment. Why, ordinarily, must the New Jersey court do so?

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4.3: The Problem of Jurisdiction

Learning Objectives

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

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

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

The Federal-State Balance: Federalism

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

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

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

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

a. Patent. The exclusive right to make, use, or sell an invention for a specified period (usually seventeen years), granted by the federal government to the inventor if the device or process is novel, useful, and nonobvious.
b. Copyright. The body of law relating to a property right in an original work of authorship (such as a literary, musical, artistic, photographic, or film work) fixed in any tangible medium of expression, giving the holder the exclusive right to reproduce, adapt, distribute, perform, and display the work.
c. Trademark. A word, phrase, logo, or other graphic symbol used by a manufacturer or seller to distinguish its product or products from those of others.

6. Admiralty. The system of laws that has grown out of the practice of admiralty courts: 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)

OR

A federal court will have subject matter jurisdiction over any case based on state law where the parties are (1) from different states and (2) the amount in controversy is at least $75,000.

(1) The different states requirement means that no plaintiff can have permanent residence in a state where any defendant has permanent residence—there must be complete diversity of citizenship as between all plaintiffs and defendants.

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

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

4. In diversity cases, the following rules apply.

(1) Federal civil procedure rules apply to how the case is conducted before and during trial and any appeals, but

(2) State law will be used as the basis for a determination of legal rights and responsibilities.

(a) This "choice of law" process is interesting but complicated. Basically, each state has its own set of judicial decisions that resolve conflict of laws. For example, just because A sues B in a Texas court, the Texas court will not necessarily apply Texas law. Anna and Bobby collide and suffer serious physical injuries while driving their cars in Roswell, New Mexico. Both live in Austin, and Bobby files a lawsuit in Austin. The court there could hear it (having subject matter jurisdiction and personal jurisdiction over Bobby) but would apply New Mexico law, which governs motor vehicle laws and accidents in New Mexico. Why would the Texas judge do that?

(b) The Texas judge knows that which state's law is chosen to apply to the case can make a decisive difference in the case, as different states have different substantive law standards. For example, in a breach of contract case, one state's version of the Uniform Commercial Code may be different from another's, and which one the court decides to apply is often exceedingly good for one side and dismal for the other. In Anna v. Bobby, if Texas has one kind of comparative negligence statute and New Mexico has a different kind of comparative negligence statute, who wins or loses, or how much is awarded, could well depend on which law applies. Because both were under the jurisdiction of New Mexico's laws at the time, it makes sense to apply New Mexico law.

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

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

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

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

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

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

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

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

robinson v. audi

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

They file in an Oklahoma state court, but how will they (their attorney or the court) know if the state court has subject matter jurisdiction? Unless the case is required to be in a federal court (i.e., unless the federal courts have exclusive jurisdiction over this kind of case), any state court system will have subject matter jurisdiction, including Oklahoma's state court system.

But if their claim is for a significant amount of money, they cannot file in small claims court, probate court, or any court in Oklahoma that does not have statutory jurisdiction over their claim. They will need to file in a court of general jurisdiction. In short, even filing in the right court system (state versus federal), the plaintiff must be careful to find the court that has subject matter jurisdiction.

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

Table 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 "Alternative Means of Resolving Disputes", we will discuss other dispute-resolution forums, such as arbitration and mediation.

For now, let us consider how courts make decisions in civil disputes. Judicial decision making in the context of litigation (civil lawsuits) is a distinctive form of dispute resolution.

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

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

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

decision from this cross-fire of evidence and argument.

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

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

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

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

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

How a Case Proceeds

Complaint and Summons

Beginning a lawsuit is simple and is spelled out in the rules of procedure by which each court system operates. In the federal system, the plaintiff begins a lawsuit by filing a complaint—a document clearly explaining the grounds for suit—with the clerk of the court. The court's agent (usually a sheriff, for state trial courts, or a US deputy marshal, in federal district courts) will then serve the defendant with the complaint and a summons. The summons is a court document stating the name of the plaintiff and his attorney and directing the defendant to respond to the complaint within a fixed time period.
The timing of the filing can be important. Almost every possible legal complaint is governed by a federal or state statute of limitations, which requires a lawsuit to be filed within a certain period of time. For example, in many states a lawsuit for injuries resulting from an automobile accident must be filed within two years of the accident or the plaintiff forfeits his right to proceed. As noted earlier, making a correct initial filing in a court that has subject matter jurisdiction is critical to avoiding statute of limitations problems.

Jurisdiction and Venue

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

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

Service of Process and Personal Jurisdiction

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

One of the most troublesome problems is service on an out-of-state defendant. The personal jurisdiction of a state court over persons is clear for those defendants found within the state. If the plaintiff claims that an out-of-state defendant injured him in some way, must the plaintiff go to the defendant's home state to serve him? Unless the defendant had some significant contact with the plaintiff's state, the plaintiff may indeed have to. For instance, suppose a traveler from Maine stopped at a roadside diner in Montana and ordered a slice of homemade pie that was tainted and caused him to be sick. The traveler may not simply return home and mail the diner a notice that he is suing it in a Maine court. But if out-of-state defendants have some contact with the plaintiff's state of residence, there might be grounds to bring them within the jurisdiction of the plaintiff's state courts. In *Burger King v. Rudzewicz*, Section 3.9 "Cases", 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.

a. But if the plaintiff loses against defendant 1, he can go elsewhere (to another state or states) and sue defendants 2, 3, 4, or 5.

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

This involves the principle of res judicata, which means that you can't bring the same action against the same person (or entity) twice. It's like the civil side of double jeopardy. Res means "thing," and judicata means "adjudicated." Thus the "thing" has been "adjudicated" and should not be judged again. But, as to nonparticipating parties, it is not over. If you have a different case against the same defendant—one that arises out of a completely different situation—that case is not barred by res judicata.

3. Service of process is a necessary (but not sufficient) condition for getting personal jurisdiction over a particular defendant (see rule 4).

a. 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.
b. There are many ways to do this.

- The process server personally serves a complaint on the defendant.
- The process server leaves a copy of the summons and complaint at the residence of the defendant, in the hands of a competent person.
- The process server sends the summons and complaint by certified mail, return receipt requested.
- The process server, if all other means are not possible, notifies the defendant by publication in a newspaper having a minimum number of readers (as may be specified by law).

4. In addition to successfully serving the defendant with process, a plaintiff must convince the court that exercising personal jurisdiction over the defendant is consistent with due process and any statutes in that state that prescribe the jurisdictional reach of that state (the so-called long-arm statutes). The Supreme Court has long recognized various bases for judging whether such process is fair.

1. Consent. The defendant agrees to the court's jurisdiction by coming to court, answering the complaint, and having the matter litigated there.
2. Domicile. The defendant is a permanent resident of that state.
3. Event. The defendant did something in that state, related to the lawsuit, that makes it fair for the state to say, "Come back and defend!"
4. Service of process within the state will effectively provide personal jurisdiction over the nonresident.

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

Almost every state in the United States has a statute regarding personal jurisdiction, instructing judges when it is permissible to assert personal jurisdiction over an out-of-state resident. These are called long-arm statutes. But no state can reach out beyond the limits of what is constitutionally permissible under the Fourteenth Amendment, which binds the states with its proviso to guarantee the due process rights of the citizens of every state in the union. The "minimum contacts" test in Burger King v. Rudzewicz (Section 3.9 "Cases") 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 "Sample Conflict-of-Law Principles"). 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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4.4: Motions and Discovery

Learning Objectives

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

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

Initial Pleadings, and Motions to Dismiss

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

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

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

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

Discovery

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

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

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

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

Key Takeaway

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

Exercises

1. Mrs. Robinson (in the Volkswagen Audi case) never establishes residency in Arizona, returns to New York, and files her case in federal district court in New York, alleging diversity jurisdiction. Assume that the defendants do not want to have the case heard in federal court. What motion will they make?
2. Under contributory negligence, the negligence of any plaintiff that causes or contributes to the injuries a plaintiff complains of will be grounds for dismissal. Suppose that in discovery, Mr. Ferlito in *Ferlito v. Johnson & Johnson* (Section 3.9 "Cases") 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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4.5: The Pretrial and Trail Phase

Learning Objectives

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

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

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

Pretrial Conference

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

Trial

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Posttrial Motions

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

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

Rule 50(b) says,

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

Key Takeaway

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

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

Exercises

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

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4.6: Judgment, Appeal, and Execution

Learning Objectives

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

Judgment or Order

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

Appeal

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

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

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

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

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

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

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

Judgment and Order

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

Key Takeaway

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

Exercises

1. Mrs. Robinson has a key witness on auto safety that the judge believes is not qualified as an expert. The judge examines the witness while the jury is in the jury room and disqualifies him from testifying. The jury does not get to hear this witness. Her attorney objects. She loses her case. What argument would you expect Mrs. Robinson's attorney to make in an appeal?
2. Why don't appellate courts need a witness box for witnesses to give testimony under oath?
3. A trial judge in Nevada is wondering whether to enforce a surrogate motherhood contract. Penelope Barr, of Reno, Nevada, has contracted with Reuben and Tina Goldberg to bear the in vitro fertilized egg of Mrs. Goldberg. After carrying the child for nine months, Penelope gives birth, but she is reluctant to give up the child, even though she was paid $20,000 at the start of the contract and will earn an additional $20,000 on handing over the baby to the Goldbergs. (Barr was an especially good candidate for surrogate motherhood: she had borne two perfect children and at age 28 drinks no wine, does not smoke or use drugs of any kind, practices yoga, and maintains a largely vegetarian diet with just enough meat to meet the needs of the fetus within.)

   The Goldbergs have asked the judge for an order compelling Penelope to give up the baby, who was five days old when the lawsuit was filed. The baby is now a month old as the judge looks in vain for guidance from any Nevada statute, federal statute, or any prior case in Nevada that addressed the issue of surrogate motherhood. He does find several well-reasoned cases, one from New Jersey, one from Michigan, and one from Oregon. Are any of these "precedent" that he must follow? May he adopt the reasoning of any of these courts, if he should find that reasoning persuasive?

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4.7: When Can Someone Bring a Lawsuit?

Learning Objectives

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

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

Case or Controversy: Standing to Sue

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

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

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

Class Actions

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

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

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

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

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

Key Takeaway

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

Exercise

1. Fuchs Funeral Home is carrying the body of Charles Emmenthaler to its resting place at Forest Lawn Cemetery. Charles's wife, Chloe, and their two children, Chucky and Clarice, are following the hearse when the coffin falls on the street, opens, and the body of Charles Emmenthaler falls out. The wife and children are shocked and aggrieved and later sue in civil court for damages. Assume that this is a viable cause of action based on "negligent infliction of emotional distress" in the state of California and that Charles's brother, sister-in-law, and multiple cousins also were in the funeral procession and saw what happened. The brother of Charles, Kingston Emmenthaler, also sees his brother's body on the street, but his wife, their three children, and some of Charles's other cousins do not.

Charles was actually emotionally closest to Kingston's oldest son, Nestor, who was studying abroad at the time of the funeral and could not make it back in time. He is as emotionally distraught at his uncle's passing as anyone else in the family and is especially grieved over the description of the incident and the grainy video shot by one of the cousins on his cell phone. Who has standing to sue Fuchs Funeral Home, and who does not?

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4.8: Relations with Lawyers

Learning Objectives

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

Legal Fees

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

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

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

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

Costs

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

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

Key Takeaway

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

Exercises

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

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

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4.9: Alternative Means of Resolving Disputes

Learning Objectives

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

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

Arbitration

Beginning around 1980, a movement toward alternative dispute resolution began to gain force throughout the United States. Bar associations, other private groups, and the courts themselves wanted to find quicker and cheaper ways for litigants and potential litigants to settle certain types of quarrels than through the courts. As a result, neighborhood justice centers or dispute resolution centers have sprung up in communities. These are where people can come for help in settling disputes, of both civil and criminal nature, that should not consume the time and money of the parties or courts in lengthy proceedings.
These alternative forums use a variety of methods, including arbitration, mediation, and conciliation, to bring about agreement or at least closure of the dispute. These methods are not all alike, and their differences are worth noting.

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

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

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

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

Mediation

Unlike adjudication,**mediation** gives the neutral party no power to impose a decision. The mediator is a go-between who attempts to help the parties negotiate a solution. The mediator will communicate the parties' positions to each other, will facilitate the finding of common ground, and will suggest outcomes. But the parties have complete control: they may ignore the recommendations of the mediator entirely, settle in their own way, find another mediator, agree to binding arbitration, go to court, or forget the whole thing!

Key Takeaway

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

Exercises

1. When Mrs. Robinson buys her Audi from Seaway, there is a paragraph in the bill of sale, which both the dealer and Mrs. Robinson sign, that says, "In the event of any complaint by customer/buyer against Seaway regarding the vehicle purchased herein, such complaint shall not be litigated, but may only be arbitrated under the rules of the American Arbitration Association and in accordance with New York law." Mrs. Robinson did not see the provision, doesn't like it, and wants to bring a lawsuit in Oklahoma against Seaway. What 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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5: DISPUTES AND DISPUTE SETTLEMENT

5.1: Introduction
5.2: Negotiation
5.3: Mediation
5.4: Arbitration
5.5: End Notes
5.6: Assessment Questions

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5.1: Introduction

Learning Objectives

- Explain the theory, practice, and law of disputes and resolution.



Figure 5.1.1: Introduction (Credit: rawpixel/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

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5.2: Negotiation

We frequently engage in negotiations as we go about our daily activities, often without being consciously aware that we are doing so. Negotiation can be simple, e.g., two friends deciding on a place to eat dinner, or complex, e.g., governments of several nations trying to establish import and export quotas across multiple industries. When a formal proceeding is started in the court system, **alternative dispute resolution (ADR)**, or ways of solving an issue with the intent to avoid **litigation**, may be employed. Negotiation is often the first step used in ADR. While there are other forms of alternative dispute resolution, negotiation is considered to be the simplest because it does not require outside parties. An article in the **Organization Behavior and Human Decision Processes** defined **negotiation** as the "process by which parties with nonidentical preferences allocate resources through interpersonal activity and joint decision making." Analyzing the various components of this definition is helpful in understanding the theories and practices involved in negotiation as a form of dispute settlement.

Negotiation Types and Objectives

Per the above definition, negotiation becomes necessary when two parties hold "non-identical" preferences. This statement seems fairly obvious, since 100% agreement would indicate that there is not any need for negotiation. From this basic starting point, there are several ways of thinking about negotiation, including how many parties are involved. For example, if two small business owners find themselves in a disagreement over property lines, they will frequently engage in **dyadic negotiation**. Put simply, dyadic negotiation involves two individuals interacting with one another in an attempt to resolve a dispute. If a third neighbor overhears the dispute and believes one or both of them are wrong with regard to the property line, then **group negotiation** could ensue. Group negotiation involves more than two individuals or parties, and by its very nature, it is often more complex, time-consuming, and challenging to resolve.

While dyadic and group negotiations may involve different dynamics, one of the most important aspects of any negotiation, regardless of the quantity of negotiators, is the objective. Negotiation experts recognize two major goals of negotiation: relational and outcome. **Relational goals** are focused on building, maintaining, or repairing a partnership, connection, or rapport with another party. **Outcome goals**, on the other hand, concentrate on achieving certain end results. The goal of any negotiation is influenced by numerous factors, such as whether or not there will be contact with the other party in the future. For example, when a business negotiates with a supply company that it intends to do business with in the foreseeable future, it will try to focus on "win-win" solutions that provide the most value for each party. In contrast, if an interaction is of a one-time nature, that same company might approach a supplier with a "win-lose" mentality, viewing its objective as maximizing its own value at the expense of the other party's value. This approach is referred to as **zero-sum negotiation**, and it is considered to be a "hard" negotiating style. Zero-sum negotiation is based on the notion that there is a "fixed pie," and the larger the slice that one party receives, the smaller the slice the other party will receive. Win-win approaches to negotiation are sometimes referred to as **integrative**, while win-lose approaches are called **distributive**.



Figure 5.2.1: Certain negotiation styles adopt a

mindset in which the extent of one's win is proportional to the other's loss. (Credit: Sebastian Voortman/ pexels/ License: CC0)

Negotiation Style

Everyone has a different way of approaching negotiation, depending on the circumstance and the person's personality. However, the **Thomas-Kilmann Conflict Mode Instrument (TKI)** is a questionnaire that provides a systematic framework for categorizing five broad negotiation styles. It is closely associated with work done by conflict resolution experts Dean Pruitt and Jeffrey Rubin. These styles are often considered in terms of the level of self-interest, instead of how other negotiators feel. These five general negotiation styles include:

- **Forcing**. If a party has high concern for itself, and low concern for the other party, it may adopt a competitive approach that only takes into account the outcomes it desires. This negotiation style is most prone to zero-sum thinking. For example, a car dealership that tries to give each customer as little as possible for his or her trade-in vehicle would be applying a forcing negotiation approach. While the party using the forcing approach is only considering its own self-interests, this negotiating style often undermines the party's long-term success. For example, in the car dealership example, if a customer feels she has not received a fair trade-in value after the sale, she may leave negative reviews and will not refer her friends and family to that dealership and will not return to it when the time comes to buy another car.
- **Collaborating**. If a party has high concern and care for both itself and the other party, it will often employ a collaborative negotiation that seeks to maximum the gain for both. In this negotiating style, parties recognize that acting in their mutual interests may create greater value and synergies.
- **Compromising**. A compromising approach to negotiation will take place when parties share some concerns for both themselves and the other party. While it is not always possible to collaborate, parties can often find certain points that are more important to one versus the other, and in that way, find ways to isolate what is most important to each party.
- **Avoiding**. When a party has low concern for itself and for the other party, it will often try to avoid negotiation completely.
- **Yielding**. Finally, when a party has low self-concern for itself and high concern for the other party, it will yield to demands that may not be in its own best interest. As with avoidance techniques, it is important to ask why the party has low self-concern. It may be due to an unfair power differential between the two parties that has caused the weaker party to feel it is futile to represent its own interests. This example illustrates why negotiation is often fraught with ethical issues.

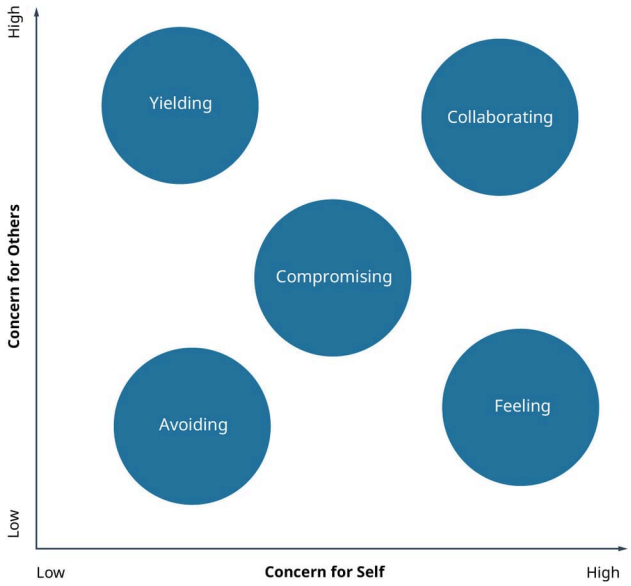


Figure 5.2.2: Concern for self vs. others leads to the differences in negotiating styles. (Modification of art by BNED/Rubin Credit: CC BY NC SA)

Negotiation Styles in Practice

Apple's response to its treatment of warranties in China, i.e., giving one-year warranties instead of two-year warranties as required by law, serves as an example of how negotiation may be used. While Apple products continued to be successful and popular in China, the issue rankled its customers, and Chinese celebrities joined the movement to address the concern. Chinese consumers felt that Apple was arrogant and didn't value its customers or the customers' feedback. In response, Tim Cook issued a public apology in which he expressed regret over the misunderstanding, saying, "We are aware that insufficient communications during

this process has led to the perception that Apple is arrogant and disregards, or pays little attention to, consumer feedback. We express our sincere apologies for any concern or misunderstanding arising therefrom." Apple then listed four ways it intended to resolve the matter. By exhibiting humility and concern for its customers, Apple was able to diffuse a contentious situation that might have resulted in costly litigation.

Negotiation Laws

Negotiations are covered by a medley of federal and state laws, such as the **Federal Arbitration Act** and **Uniform Arbitration Act**. The Federal Arbitration Act (FAA) is a national policy that favors arbitration and enforces situations in which parties have contractually agreed to participate in arbitration. Parties who have decided to be subject to binding arbitration relinquish their constitutional right to settle their dispute in court. It is the FAA that allows parties to confirm their awards, as will be discussed in the following chapters. When considering negotiation laws, it is important to keep in mind that each state has laws with their own definitions and nuances. While the purpose of the Uniform Arbitration Act in the United States was to provide a uniform approach to the way states handle arbitration, it has only been adopted in some form by about 35 states.

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5.3: Mediation

Court or Agency-Connected Mediation

Mediation is a method of dispute resolution that relies on an impartial third-party decision-maker, known as a **mediator**, to settle a dispute. While requirements vary by state, a mediator is someone who has been trained in conflict resolution, though often, he or she does not have any expertise in the subject matter that is being disputed. Mediation is another form of alternative dispute resolution. It is often used in attempts to resolve a dispute because it can help disagreeing parties avoid the time-consuming and expensive procedures involved in court litigation. Courts will often recommend that a **plaintiff**, or the party initiating a lawsuit, and a **defendant**, or the party that is accused of wrongdoing, attempt mediation before proceeding to trial. This recommendation is especially true for issues that are filed in small claims courts, where judges attempt to streamline dispute resolution. Not all mediators are associated with public court systems. There are many agency-connected and private mediation services that disputing parties can hire to help them potentially resolve their dispute. The American Bar Association suggests that, in addition to training courses, one of the best ways to start a private mediation business is to volunteer as a mediator. Research has shown that experience is an important factor for mediators who are seeking to cultivate sensitivity and hone their conflict resolution skills.

For businesses, the savings associated with mediation can be substantial. For example, the energy corporation Chevron implemented an internal mediation program. In one instance, it cost $25,000 to resolve a dispute using this internal mediation program, far less than the estimated $700,000 it would have incurred through the use of outside legal services. Even more impressive is the amount it saved by not going to court, which would have cost an estimated $2.5 million.

Mediation is distinguished by its focus on solutions. Instead of focusing on discoveries, testimonies, and expert witnesses to assess what has happened in the past, it is future-oriented. Mediators focus on discovering ways to solve the dispute in a way that will appease both parties.

Other Benefits of Mediation

- **Confidentiality**. Since court proceedings become a matter of public record, it can be advantageous to use mediation to preserve anonymity. This aspect can be especially important when dealing with sensitive matters, where one or both parties feels it is best to keep the situation private.
- **Creativity**. Mediators are trained to find ways to resolve disputes and may apply outside-the-box thinking to suggest a resolution that the parties had not considered. Since disagreeing parties can be feeling emotionally contentious toward one another, they may not be able to consider other solutions. In addition, a skilled mediator may be able to recognize cultural differences between the parties that are influencing the parties' ability to reach a compromise, and thus leverage this awareness to create a novel solution.
- **Control**. When a case goes to trial, both parties give up a certain degree of control over the outcome. A judge may come up with a solution to which neither party is in favor. In contrast, mediation gives the disputing parties opportunities to find common ground on their own terms, before relinquishing control to outside forces.

Role of the Mediator

Successful mediators work to immediately establish personal rapport with the disputing parties. They often have a short period of time to interact with the parties and work to position themselves as a trustworthy advisor. The Harvard Law School Program on Negotiation reports a study by mediator Peter Adler in which mediation participants remembered the mediators as "opening the room, making coffee, and getting everyone introduced." This quote underscores the need for mediators to play a role beyond mere administrative functions. The mediator's conflict resolution skills are critical in guiding the parties toward reaching a resolution.

Steps of Mediation

As explained by nolo.com, mediation, while not being as formal as a court trial, involves the following six steps:

- **Mediator's Opening Statement**: During the opening statement, the mediator introduces himself or herself and explains the goals of mediation.
- **Opening Statements of Plaintiff and Defendant**: Both parties are given the opportunity to speak, without interruption. During this opening statement, both parties are afforded the opportunity to describe the nature of the dispute and their desired solution.
- **Joint Discussion**: The mediator will try to get the two disagreeing parties to speak to one another and will guide the discussion toward a mutually amicable solution. This part of the mediation process usually identifies which issues need to be resolved and explores ways to address the issues.
- **Private Caucus**: During this stage, each party has the ability to meet and speak privately with the mediator. Typically, the mediator will use this time to learn more about what is most important to each party and to brainstorm ways to find a resolution. The mediator may ask the parties to try to put aside their emotional responses and resentments to work toward an agreement.
- **Joint Negotiation**: After the private caucuses, the parties are joined again in the same room, and the mediator presents any newly discovered insight to guide them toward an agreement.
- **Closure**: During this final stage, an agreement is reached, or it is determined that the parties cannot agree. Either way, the mediator will review the positions of each party and ask them if they would like to meet again or explore escalating options, such as moving the dispute to court.

Ethical Issues

Both the disputants themselves, and those who attempt to facilitate dispute resolutions, i.e., mediators and attorneys, must navigate a myriad of ethical issues, such as deciding whether they should tell the entire truth, or only offer a partial disclosure. This conflict has long roots in history and has often been considered in terms of consequentialist and deontological ethical theories. **Consequentialist ethics**, sometimes known as situational ethics, is a way of looking at difficult decisions by considering their implications. Someone who follows consequentialist ethics in mediation or arbitration would consider the impact of his or her decision on the parties in light of their unique circumstances. In contrast, **deontologist ethics** bases its decision on whether the action itself is right or wrong, regardless of its consequences.

Imagine a situation in which a professional accountant holds a consequentialist ethical viewpoint and believes that there are certain scenarios in which the disclosure of only part of the truth is a commendable course of action. For example, if an accountant is interviewed regarding how the company handled a certain transaction in its retirement account, he might choose to withhold certain information because he is afraid it will harm the retirees' ability to retain the full benefits of their pensions. In this case, the accountant is utilizing "the ends justify the means" logic because he feels that the omission of truth will result in more benefit than its revelation. A mediator or arbitrator who also follows a consequentialist viewpoint would consider the accountant's motivation and the circumstances, in addition to his or her actions.

Ethical situations like these are not only part of dispute mediation in business law scenarios, but also happen in daily life. Consider the case of a parent who is on his way home from work when he receives a call from the babysitter, telling him that his child's forehead feels hot and that she is complaining of not feeling well. Sitting in traffic, the parent remembers that he does not know the whereabouts of the digital thermometer, so he decides to stop and purchase one. The parking lot at the store is extremely busy, so the parent decides to park in a handicapped spot, even though he does not have any mobility challenges. These types of situations have been addressed by philosophers such as Immanuel Kant, who spoke of the **categorical imperative**, which he defined as, "Act only according to that maxim whereby you can, at the same time, will that it should become a universal law." In other words, one's action should be considered in light of what would happen if everyone were to engage in the same action. While it might not seem like a harmful infraction, if everyone were to do it, then it would cause a true inconvenience and possible suffering for mobility-impaired individuals, for whom those spaces were designated. A deontological ethical viewpoint would determine that it is always wrong to park in the handicapped space, regardless of the situation. In real life, it is very difficult to adopt a 100% deontological viewpoint for dispute resolution. Often, the reason the dispute has arisen in the first place is because of some ambiguity inherent in the situation. In these cases, mediators must apply their best judgment to help the disagreeing parties see one another's viewpoints and to guide them toward a mutually amicable solution.



Figure 5.3.1: Sometimes ethical issues have no clear-cut answers and mediators must rely upon their best judgement. (Credit: George Becker/ pexels/ License: CC0)

Future Directions in Mediation

As technology continues to change the ways we interact with one another, it is likely that we will see advances in mediation techniques. For example, there are companies that offer online mediation services, known as **e-mediation**. E-mediation can be useful in situations where the parties are geographically far apart, or the transaction in dispute took place online. Ebay uses e-mediation to handle the sheer volume of misunderstandings between parties. Research has shown that one of the benefits of e-mediation is that it allows people the time needed to "cool down" when they have to explain their feelings in an email, as opposed to speaking to others in person.

In addition to technological advancements, new findings in psychology are influencing how disputes are resolved, such as the rising interest in canine-assisted mediation (CAM), in which the presence of dogs is posited to have an impact on human emotional health. Since the presence of dogs has a positive impact on many of the neurophysiological stress markers in humans, researchers are beginning to explore the use of therapy animals to assist in dispute resolution.



Figure 5.3.2: Mediation experts are considering the benefits of therapy dogs for canine-assisted mediation. (Credit: Garfield Besa/ pexels/ License: CC0)

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5.4: Arbitration

The American Bar Association (ABA) defines arbitration as the "private process where disputing parties agree that one or several individuals can make a decision about the dispute after receiving evidence and hearing arguments." Arbitration is overseen by a neutral **arbitrator**, or an individual who is responsible for making a decision on how to resolve a dispute and who has the ability to decide on an **award**, or a course of action that the arbiter believes is fair, given the situation. An award can be a monetary payment that one party must pay to the other; however, awards need not always be financial in nature. An award may require that one business stop engaging in a certain practice that is deemed unfair to the other business. As distinguished from mediation, in which the mediator simply serves as a facilitator who is attempting to help the disagreeing parties reach an agreement, and arbitrator acts more like a judge in a court trial and often has legal expertise, although he or she may or may not have subject matter expertise. Many arbitrators are current or retired lawyers and judges.

Types of Arbitration Agreements

Parties can enter into either voluntary or involuntary arbitration. In **voluntary arbitration**, the disputing parties have decided, of their own accord, to seek arbitration as a way to potentially settle their dispute. Depending on the state's laws and the nature of the dispute, disagreeing parties may have to attempt arbitration before resorting to litigation; this requirement is known as **involuntary arbitration** because it is forced upon them by an outside party.

Arbitration can be either binding or non-binding. In **binding arbitration**, the decision of the arbitrator(s) is final, and except in rare circumstances, neither party can appeal the decision through the court system. In **non-binding arbitration**, the arbitrator's award can be thought of as a recommendation; it is only finalized if both parties agree that it is an acceptable solution. This fact is why non-binding arbitration can be useful for what the American Arbitration Association describes as "disputes where the parties may be too far apart in their viewpoints to mediate or are in need of an objective evaluation of their respective positions." Having a neutral party assess the situation may help disputants to rethink and reassess their positions and reach a future compromise.

Issues Covered by Arbitration Agreements

There are many instances in which arbitration agreements may prove helpful as a form of alternative dispute resolution. While arbitration can be useful for resolving family law matters, such as divorce, custody, and child support issues, in the domain of business law, it has three major applications:

- **Labor**. Arbitration has often been used to resolve labor disputes through interest arbitration and grievance arbitration. **Interest arbitration** addresses disagreements about the terms to be included in a new contract, e.g., workers of a union want their break time increased from 15 to 25 minutes. In contrast, **grievance arbitration** covers disputes about the implementation of existing agreements. In the example previously given, if the workers felt they were being forced to work through their 15-minute break, they might engage in this type of arbitration to resolve the matter.
- **Business Transactions**. Whenever two parties conduct business transactions, there is potential for misunderstandings and mistakes. Both business-to-business transactions and business-to-consumer transactions can potentially be solved through arbitration. Any individual or business who is unhappy with a business transaction can attempt arbitration. Jessica Simpson recently won an arbitration case in which she disputed the release of a fitness video she had made because she felt the editor took too long to release it.
- **Property Disputes**. Business can have various types of property disputes. These might include disagreements over physical property, e.g., deciding where one property ends and another begins, or intellectual property, e.g., trade secrets, inventions, and artistic works.

Typically, civil disputes, as opposed to criminal matters, attempt to use arbitration as a means of dispute resolution. While definitions can vary between municipalities, states, and countries, a **civil matter** is generally one that is brought when on party has a grievance against another party and seeks monetary damages. In contrast, in a **criminal matter**, a government pursues an individual or group for violating laws meant to establish the best interests of the public. While the word **crime** often invokes the idea of violence, there are many crimes, such as embezzlement, in which the harm caused is not physical, but rather monetary.

Ethics of Commercial Arbitration Clauses

As previously discussed, going to court to solve a dispute is a costly endeavor, and for large companies, it is possible to incur millions of dollars in legal expenses. While arbitration is meant to be a form of dispute resolution that helps disagreeing parties find a low-cost, time-efficient solution, it has become increasingly important to question whose expenses are being lowered, and to what effect. Many consumer advocates are fighting against what are known as **forced-arbitration clauses**, in which consumers agree to settle all disputes through arbitration, effectively waiving their right to sue a company in court. Some of these forced arbitration clauses cause the other party to forfeit their right to appeal an arbitration decision or participate in any kind of **class action lawsuit**, in which individuals who have a similar issue sue as one collective group. For example, in 2006, Enron investors initiated a class action lawsuit against executives who hid the company's losses and were awarded $7.2 billion dollars. While this example represents a case where the company being sued was clearly in the wrong, it is important for large companies to be ethical in their use of arbitration clauses. They should not be used as a way to keep wrongdoings "quiet" or to limit consumers' abilities to obtain rightful retribution for products and services that do not perform as promised.

Arbitration Procedures

When parties enter into arbitration, certain procedures are followed. First, the number of arbitrators is decided, along with how they will be chosen. Parties that enter into willing arbitration may have more control over this decision, while those that do so unwillingly may have a limited pool of arbitrators from which to choose. In the case of willing arbitration, parties may decide to have three arbitrators, one chosen by each of the disputants and the third chosen by the elected arbitrators.

Next, a timeline is established, and evidence is presented by both parties. Since arbitration is less formal than court proceedings, the evidence phase typically goes faster than it would in a courtroom setting. Finally, the arbitrator will make a decision and usually makes one or more awards.

Not all arbitration agreements have the same procedures. It depends on the types of agreements made in advance by the disputing parties. Consider the following scenario: the owner of a large commercial office building uses a lease agreement, which stipulates that arbitration will be used to settle the renewal terms of a lease. For example, the lease may state that, at the end of year one, the second year's lease payment will be at current market value, and if the tenants cannot agree on that value, they will then allow an arbitrator to decide. If the building owner feels that the renewal rate should be $40/square foot and the tenant feels it should be $20/square foot, an arbiter who may not be an expert in local real estate values might decide to resolve the dispute by using a rule of thumb, such as "splitting the difference." In this case, the arbiter might decide that $30/square foot represents a fair lease renewal rate.



Figure 5.4.1: Various types of arbitration can be employed depending on what the parties think is best for their situation. (Credit: Tim Eiden/ pexels/ License: CC0)

To overcome this shortcoming, the building owner could write a lease agreement that stipulates that the parties use binding **baseball arbitration** and use subject matter experts as arbitrators. In this case, that might include real estate attorneys or

commercial real estate investors. In baseball arbitration, each party would submit a lease renewal figure to an arbitrator. For example, imagine that the renewing tenant submits an offer of $10/per square foot, which is very much under market value, while the building owner submits an offer of $35/square foot. In this scenario, the arbitrator chooses one offer or the other, without modification. This type of arbitration incentivizes both parties to be fair in their dealings with one another because to do otherwise would be to their own detriment.

Arbitration Awards

An arbiter can issue either a "bare bones" or a reasoned award. A **bare bones** award refers to one in which the arbitrator simply states his or her decision, while a **reasoned** award lists the rationale behind the decision and award amount. The decision of the arbitrator is often converted to a judgement, or legal tool that allows the winning party to pursue collection action on the award. The process of converting an award to a judgement is known as confirmation.

Judicial Enforcement of Arbitration Awards

While it might seem that the party that is awarded a settlement by an arbitrator has reason to be relieved that the matter is resolved, sometimes this decision represents just one more step toward actually receiving the award. While a party may honor the award and voluntarily comply, this outcome is not always the case. In cases where the other party does not comply, the next step is to petition the court to enforce the arbitrator's decision. This task can be accomplished by numerous mechanisms, depending on the governing laws. These include writs of execution, garnishment, and liens.

- **Writ of Execution**. Cornell Law School defines a writ of execution as "A court order that directs law enforcement personnel to take action in an attempt to satisfy a judgment won by the plaintiff."
- **Garnishment**. A garnishment refers to a court order that seizes the money, typically wages, to satisfy a debt. A myriad of laws apply to wage garnishment, e.g., certain types of income, such as Social Security Disability Income (SSDI), cannot be garnished. In addition, depending on state laws, sometimes only debtors who make over a certain amount, e.g. $1,600 gross/month, are subject to wage garnishment.
- **Liens**. A lien gives the entitled party in a judgement the right to seize the property of another to satisfy a debt. Commonly, liens can be placed on real estate and personal property, such as automobiles and boats. Property that has a lien cannot be sold because the title is encumbered and often cannot be legally transferred until the lien is satisfied, or paid. Depending on state laws, only certain property is subject to a lien. For example, the winning party in an arbitration case may only be able to place a lien on the other party's vehicle if it has a market value of over $7,500.

The enforcement of arbitration awards is governed by a number of laws, such as Federal Arbitration Act and Uniform Arbitration Act.

Summary

Negotiation, mediation, and arbitration are alternatives form of dispute resolution that attempt to help disagreeing parties avoid the time and expense of court litigation. While negotiation is involved in all three forms, mediation and arbitration involve a neutral third party to help the parties find a solution. Frameworks that consider self-interest, as opposed to interest in the other party, can help negotiators craft successful negotiation approaches. Mediators, arbitrators, and groups of arbitrators all follow certain steps and play in important role in trying to help parties reach common ground and avoid court proceedings. Mediators who establish rapport with disputing parties can facilitate dispute resolution, as mediation is very much solution-focused. Arbitrators must often decide upon awards when parties cannot reach an agreement. Even when an aggrieved party attains an arbitration award, it may still have to pursue the other party by using a variety of legal techniques to enforce the payment or practice stipulated by the award. Staying current with federal and state laws associated with negotiation proceedings is essential for businesses looking to maximize their relational and outcome goals.

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5.6: Assessment Questions

1. A process in which a third party selected by the disputants helps the parties to voluntarily resolve their disagreement is known as:
   a. Mediation.
   b. Discovery.
   c. Arbitration.
   d. Settlement.

   Answer

   a

2. What's the first step in Alternative Dispute Resolution?
   a. Conciliation.
   b. Mediation.
   c. Negotiation.
   d. Arbitration.
3. What's the definition of negotiation?

   Answer

   The process by which parties with nonidentical preferences allocate resources through interpersonal activity and joint decision making.

4. How does the process of negotiation work?
5. Explain the Thomas-Kilmann Conflict Mode Instrument.

   Answer

   The Thomas-Kilmann Conflict Mode Instrument (TKI) is a questionnaire that provides a systematic framework for categorizing five broad negotiation styles. It is closely associated with work done by conflict resolution experts Dean Pruitt and Jeffrey Rubin. These styles are often considered in terms of the level of self-interest, instead of how other negotiators feel. These five general negotiation styles include:

   Forcing. If a party has high concern for itself, and low concern for the other party, it may adopt a competitive approach that only takes into account the outcomes it desires. This negotiation style is most prone to zero-sum thinking. For example, a car dealership that tries to give each customer as little as possible for his or her trade-in vehicle would be applying a forcing negotiation approach. While the party using the forcing approach is only considering its own selfinterests, this negotiating style often undermines the party's long-term success. For example, in the car dealership example, if a customer feels she has not received a fair trade-in value after the sale, she may leave negative reviews and will not refer her friends and family to that dealership and will not return to it when the time comes to buy another car. Collaborating.

   Collaborating. If a party has high concern and care for both itself and the other party, it will often employ a collaborative negotiation that seeks to maximum the gain for both. In this negotiating style, parties recognize that acting in their mutual interests may create greater value and synergies.

   Compromising. A compromising approach to negotiation will take place when parties share some concerns for both themselves and the other party. While it is not always possible to collaborate, parties can often find certain points that are more important to one versus the other, and in that way, find ways to isolate what is most important to each party.

6. A person trained in conflict resolution is considered:
   a. An arbitrator.
   b. A mediator.
   c. A negotiator.

d. A judge.

7. Mediation focuses on:
   a. Solutions.
   b. Testimony.
   c. Expert witnesses.
   d. Discoveries.

Answer

a

8. Name the steps in Mediation.
9. What's the main benefit of e-mediation?

Answer

E-mediation can be useful in situations where the parties are geographically far apart, or the transaction in dispute took place online. Ebay uses e-mediation to handle the sheer volume of misunderstandings between parties. Research has shown that one of the benefits of e-mediation is that it allows people the time needed to "cool down" when they have to explain their feelings in an email, as opposed to speaking to others in person.

In addition to technological advancements, new findings in psychology are influencing how disputes are resolved, such as the rising interest in canine-assisted mediation (CAM), in which the presence of dogs is posited to have an impact on human emotional health. Since the presence of dogs has a positive impact on many of the neurophysiological stress markers in humans, researchers are beginning to explore the use of therapy animals to assist in dispute resolution.

10. Roger and Larry are having a dispute regarding their joint business. They want to have a binding resolution to their dispute, but they would prefer to have the dispute handled privately and by someone with special expertise. The best form of dispute resolution for their problem would be:
    a. Arbitration.
    b. Litigation.
    c. Mediation.
    d. Summary Jury Trial.
11. All of the following are methods to enforce an arbitrator's decision except:
    a. Writs of Execution.
    b. Garnishment.
    c. Fines.
    d. Liens.

Answer

c

12. Describe the typical steps in Arbitration.
13. Explain the differences between binding and non-binding arbitration.

Answer

In binding arbitration, the decision of the arbitrator is final, and except in rare circumstances, neither party can appeal the decision through the court system. In non-binding arbitration, the arbitrator's award can be thought of as a recommendation: it is only finalized if both parties agree that it is an acceptable solution.

14. All of the following are the most common applications of arbitration in the business context except:
    a. Labor.
    b. Business Transactions.
    c. Property Disputes.
    d. Torts.
15. The following are the type of awards that may be issue by an arbitrator:

a. Bare Bones.
b. Reasoned.
c. Both a and b.
d. Neither a nor b.

Answer

c

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6: CONSTITUTIONAL LAW AND US COMMERCE

6.1: Basic Aspects of the US Constitution

6.2: The Commerce Clause

6.3: Dormant Commerce Clause

6.4: Preemption- The Supremacy Clause

6.5: Business and the Bill of Rights

6.6: Cases

6.7: Summary and Exercises

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6.1: 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—fifty years ago—when "un-American" activities were under investigation in Congress and the press; the fear of communism (as antithetical to American values and principles) was paramount. As you look at the Constitution and how it affects the legal environment of business, please consider what basic values it may impart to us and what makes it uniquely American and worth defending "against all enemies, foreign and domestic."

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

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

General Structure of the Constitution

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

Federalism

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

Separation of Powers and Judicial Review

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

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

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

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

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

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

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

The Constitution does not explicitly mention any right of privacy. In a line of decisions, however, the Court has recognized that a

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

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

Key Takeaway

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

Exercises

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

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6.2: 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. 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.*Katzenbach v. McClung*, 379 US 294 (1964).

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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6.3: 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.

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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6.4: 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.

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. 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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6.5: 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 Lindsay Lohan and Jon Stewart have the same burden to go forward with a defamation action. It is for this reason that the *National Enquirer* writes 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* (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.

But substantive due process has seen fairly limited use since the 1930s. During the 1990s, the Supreme Court was asked to recognize a general right to die under the doctrine of substantive due process. Although the court stopped short of establishing such a far-reaching right, certain patients may exercise a constitutional liberty to hasten their deaths under a narrow set of circumstances. In *Cruzan v. Missouri Department of Health*, the Supreme Court ruled that the due process clause guarantees the right of competent adults to make advanced directives for the withdrawal of life-sustaining measures should they become incapacitated by a disability that leaves them in a persistent vegetative state.*Cruzan v. Missouri Department of Health*, 497 US 261 (1990). Once it has been established by clear and convincing evidence that a mentally incompetent and persistently vegetative patient made such a prior directive, a spouse, parent, or other appropriate guardian may seek to terminate any form of artificial hydration or nutrition.

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 not too long ago.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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6.6: Cases

Griswold v. Connecticut

Griswold v. Connecticut

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

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

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

Plurality Opinion by Justice William O. Douglass

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

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

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

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

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

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

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

States Constitution. And that I cannot do.

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

...

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

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

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

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

Case Questions

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

Wickard v. Filburn

Wickard v. Filburn

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

Mr. Justice Jackson delivered the opinion of the Court.

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

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

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

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

Kassel v. Consolidated Freightways Corp.

Kassel v. Consolidated Freightways Corp.

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

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

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

I

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

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

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

...

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

In a 14-day trial, both sides adduced evidence on safety and on the burden on interstate commerce imposed by Iowa's law. On the question of safety, the District Court found that the "evidence clearly establishes that the twin is as safe as the semi." 475 F.Supp. 544, 549 (SD Iowa 1979). For that reason, "there is no valid safety reason for barring twins from Iowa's highways because

of their configuration....The evidence convincingly, if not overwhelmingly, establishes that the 65-foot twin is as safe as, if not safer than, the 60-foot twin and the 55-foot semi...."

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

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

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

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

II

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

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

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

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

III

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

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

A

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

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

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

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

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

B

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

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

In addition to increasing the costs of the trucking companies (and, indirectly, of the service to consumers), Iowa's law may

aggravate, rather than, ameliorate, the problem of highway accidents. Fifty-five-foot singles carry less freight than 65-foot doubles. Either more small trucks must be used to carry the same quantity of goods through Iowa or the same number of larger trucks must drive longer distances to bypass Iowa. In either case, as the District Court noted, the restriction requires more highway miles to be driven to transport the same quantity of goods. Other things being equal, accidents are proportional to distance traveled. Thus, if 65-foot doubles are as safe as 55-foot singles, Iowa's law tends to increase the number of accidents and to shift the incidence of them from Iowa to other States.

[IV. Omitted]

V

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

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

It is so ordered.

Case Questions

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

Hunt v. Washington Apple Advertising Commission

Hunt v. Washington Apple Advertising Commission

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

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

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

[In] 1972, the North Carolina Board of Agriculture adopted an administrative regulation, unique in the 50 States, which in effect required all closed containers of apples shipped into or sold in the State to display either the applicable USDA grade or a notice indicating no classification. State grades were expressly prohibited. In addition to its obvious consequence—prohibiting the display of Washington State apple grades on containers of apples shipped into North Carolina—the regulation presented the Washington apple industry with a marketing problem of potentially nationwide significance. Washington apple growers annually ship in commerce approximately 40 million closed containers of apples, nearly 500,000 of which eventually find their way into North Carolina, stamped with the applicable Washington State variety and grade. [Compliance] with North Carolina's unique regulation would have required Washington growers to obliterate the printed labels on containers shipped to North Carolina, thus

giving their product a damaged appearance. Alternatively, they could have changed their marketing practices to accommodate the needs of the North Carolina market, i.e., repack apples to be shipped to North Carolina in containers bearing only the USDA grade, and/or store the estimated portion of the harvest destined for that market in such special containers. As a last resort, they could discontinue the use of the preprinted containers entirely. None of these costly and less efficient options was very attractive to the industry. Moreover, in the event a number of other States followed North Carolina's lead, the resultant inability to display the Washington grades could force the Washington growers to abandon the State's expensive inspection and grading system which their customers had come to know and rely on over the 60-odd years of its existence....

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

...

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

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

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

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

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

Despite the statute's facial neutrality, the Commission suggests that its discriminatory impact on interstate commerce was not an unintended by-product, and there are some indications in the record to that effect. The most glaring is the response of the North Carolina Agriculture Commissioner to the Commission's request for an exemption following the statute's passage in which he indicated that before he could support such an exemption, he would "want to have the sentiment from our apple producers *since they were mainly responsible for* this *legislation being passed*." [Moreover], we find it somewhat suspect that North Carolina singled out only closed containers of apples, the very means by which apples are transported in commerce, to effectuate the statute's ostensible consumer protection purpose when apples are not generally sold at retail in their shipping containers. However, we need not ascribe an economic protection motive to the North Carolina Legislature to resolve this case; we conclude that the challenged statute cannot stand insofar as it prohibits the display of Washington State grades even if enacted for the declared purpose of protecting consumers from deception and fraud in the marketplace.

...

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

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

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

Case Questions

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

Citizens United v. Federal Election Commission

Citizens United v. Federal Election Commission

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

Justice Kennedy delivered the opinion of the Court.

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

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

I

A

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

In January 2008, Citizens United released a film entitled *Hillary: The Movie*. We refer to the film as *Hillary*. It is a 90-minute documentary about then-Senator Hillary Clinton, who was a candidate in the Democratic Party's 2008 Presidential primary elections. *Hillary* mentions Senator Clinton by name and depicts interviews with political commentators and other persons, most of them quite critical of Senator Clinton....

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

B

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

C

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

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

...

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

II

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

III

The First Amendment provides that "Congress shall make no law...abridging the freedom of speech." Laws enacted to control or suppress speech may operate at different points in the speech process....The law before us is an outright ban, backed by criminal sanctions. Section 441b makes it a felony for all corporations—including nonprofit advocacy corporations—either to expressly advocate the election or defeat of candidates or to broadcast electioneering communications within 30 days of a primary election and 60 days of a general election. Thus, the following acts would all be felonies under §441b: The Sierra Club runs an ad, within the crucial phase of 60 days before the general election, that exhorts the public to disapprove of a Congressman who favors logging in national forests; the National Rifle Association publishes a book urging the public to vote for the challenger because the incumbent U.S. Senator supports a handgun ban; and the American Civil Liberties Union creates a Web site telling the public to vote for a Presidential candidate in light of that candidate's defense of free speech. These prohibitions are classic examples of censorship.

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

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

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

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

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

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

...

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

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

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

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

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

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

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

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

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

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

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

[IV. Omitted]

V

When word concerning the plot of the movie *Mr. Smith Goes to Washington* reached the circles of Government, some officials

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

Modern day movies, television comedies, or skits on YouTube.com might portray public officials or public policies in unflattering ways. Yet if a covered transmission during the blackout period creates the background for candidate endorsement or opposition, a felony occurs solely because a corporation, other than an exempt media corporation, has made the "purchase, payment, distribution, loan, advance, deposit, or gift of money or anything of value" in order to engage in political speech. 2 U.S.C. §431(9)(A)(i). Speech would be suppressed in the realm where its necessity is most evident: in the public dialogue preceding a real election. Governments are often hostile to speech, but under our law and our tradition it seems stranger than fiction for our Government to make this political speech a crime. Yet this is the statute's purpose and design.

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

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

It is so ordered.

Case Questions

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

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6.7: Summary and Exercises

Summary

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

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

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

Exercises

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

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

SELF CHECK QUESTIONS

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

AnswerS

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

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7: CRIMINAL LAW

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7.1: The Nature of 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 society 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 appropriate punishment for crimes will also vary considerably from nation to nation. Uganda has decreed long prison sentences for homosexuals and death to repeat offenders. 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 forty 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.” 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. (However, because of crowded dockets, a victim that declines to press charges may cause a busy prosecutor to choose to not to bring an indictment.)

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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7.2: Types of Crimes

Learning Objectives

1. Categorize various types of crimes.
2. Name and define the major felonies in criminal law.
3. Explain how white-collar crime differs from other crimes.
4. 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; they are increasingly rare 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. 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 "Cases") 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. It is defined as “the breaking and entering of the dwelling of another in the nighttime with intent to commit a felony.” The intent to steal is not an issue: a man who sneaks into a woman’s home intent on raping 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? When does night begin? What kind of intent? Whose dwelling? Can a landlord burglarize the dwelling of his tenant? (Yes.) Can a person burglarize his 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), cert. denied, 417 US 976 (1974).

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 "Cases") 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 "Summary of Provisions of the Computer Fraud and Abuse Act"). 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, use public goods such as the mails or the Internet to commit fraud, or commit other white-collar crimes).

Exercises

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

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7.3: The Nature of a Criminal Act

Learning Objectives

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

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

Attempt

It is not necessary to 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 men believed they were raping a drunken, unconscious woman, and were later accused of attempted rape, but defended on the grounds of factual impossibility because the woman was actually dead at the time sexual intercourse took place? Or 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 (rape requires a live victim, and 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 Barney (who has poor sight), shoots at a tree stump, thinking it is his neighbor, Ralph, 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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7.4: Responsibility

Learning Objectives

1. Explain why criminal law generally requires that the defendant charged with a crime have criminal "intent."
2. 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 "Cases", 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 take away 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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7.5: Procedure

Learning Objectives

1. Describe the basic steps in pretrial criminal procedure that follow a government's determination to arrest someone for an alleged criminal act.
2. Describe the basic elements of trial and 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 an **information** (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 twenty-three people who sit 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 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, 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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7.6: Constitutional Rights of the Accused

Learning Objectives

1. Describe the most significant constitutional rights of defendants in US courts, and name the source of these rights.
2. 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 policeman 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 2010, there were 3,300 defendants on death row in the United States. 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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7.7: Cases

False Pretenses

State v. Mills

96 Ariz. 377, 396 P.2d 5 (Ariz. 1964)

LOCKWOOD, VICE CHIEF JUSTICE

Defendants appeal from a conviction on two counts of obtaining money by false pretenses in violation of AR.S. §§ 13-661.A3. and 13-663.A1. The material facts, viewed "...in the light most favorable to sustaining the conviction," are as follows: Defendant William Mills was a builder and owned approximately 150 homes in Tucson in December, 1960. Mills conducted his business in his home. In 1960 defendant Winifred Mills, his wife, participated in the business generally by answering the telephone, typing, and receiving clients who came to the office.

In December 1960, Mills showed the complainant, Nathan Pivowar, a house at 1155 Knox Drive and another at 1210 Easy Street, and asked Pivowar if he would loan money on the Knox Drive house. Pivowar did not indicate at that time whether he would agree to such a transaction. Later in the same month Nathan Pivowar told the defendants that he and his brother, Joe Pivowar, would loan $5,000 and $4,000 on the two houses. Three or four days later Mrs. Mills, at Pivowar's request, showed him these homes again.

Mills had prepared two typed mortgages for Pivowar. Pivowar objected to the wording, so in Mills' office Mrs. Mills retyped the mortgages under Pivowar's dictation. After the mortgages had been recorded on December 31, 1960, Pivowar gave Mills a bank check for $5,791.87, some cash, and a second mortgage formerly obtained from Mills in the approximate sum of $3,000. In exchange Mills gave Pivowar two personal notes in the sums of $5,250.00 and $4,200.00 and the two mortgages as security for the loan.

Although the due date for Mills' personal notes passed without payment being made, the complainant did not present the notes for payment, did not demand that they be paid, and did not sue upon them. In 1962 the complainant learned that the mortgages which he had taken as security in the transaction were not first mortgages on the Knox Drive and Easy Street properties. These mortgages actually covered two vacant lots on which there were outstanding senior mortgages. On learning this, Pivowar signed a complaint charging the defendants with the crime of theft by false pretenses.

On appeal defendants contend that the trial court erred in denying their motion to dismiss the information. They urge that a permanent taking of property must be proved in order to establish the crime of theft. Since the complainant had the right to sue on the defendants' notes, the defendants assert that complainant cannot be said to have been deprived of his property permanently. Defendants misconceive the elements of the crime of theft by false pretenses. Stated in a different form, their argument is that although the complainant has parted with his cash, a bank check, and a second mortgage, the defendants intend to repay the loan.

Defendants admit that the proposition of law which they assert is a novel one in this jurisdiction. Respectable authority in other states persuades us that their contention is without merit. A creditor has a right to determine for himself whether he wishes to be a secured or an unsecured creditor. In the former case, he has a right to know about the security. If he extends credit in reliance upon security which is falsely represented to be adequate, he has been defrauded even if the debtor intends to repay the debt. His position is now that of an unsecured creditor. At the very least, an unreasonable risk of loss has been forced upon him by reason of the deceit. This risk which he did not intend to assume has been imposed upon him by the intentional act of the debtor, and such action constitutes an intent to defraud.

* * *

The cases cited by defendants in support of their contention are distinguishable from the instant case in that they involved theft by larceny. Since the crime of larceny is designed to protect a person's possessory interest in property whereas the crime of false pretenses protects one's title interest, the requirement of a permanent deprivation is appropriate to the former. Accordingly, we hold that an intent to repay a loan obtained on the basis of a false representation of the security for the loan is no defense.

* * *

Affirmed in part, reversed in part, and remanded for resentencing.

CASE QUESTIONS

1. False pretenses is a crime of obtaining ownership of property of another by making untrue representations of fact with intent to defraud. What were the untrue representations of fact made by Mills?
2. Concisely state the defendant's argument as to why Pivowar has not been deprived of any property.
3. If Pivowar had presented the notes and Mills had paid, would a crime have been committed?

White-Collar Crimes

United States v. Park

421 U.S. 658 (1975)

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

We granted certiorari to consider whether the jury instructions in the prosecution of a corporate officer under § 301 (k) of the Federal Food, Drug, and Cosmetic Act, 52 Stat. 1042, as amended, 21 U.S.C. § 331 (k), were appropriate under *United States v. Dotterweich*, 320 U.S. 277 (1943). Acme Markets, Inc., is a national retail food chain with approximately 36,000 employees, 874 retail outlets, 12 general warehouses, and four special warehouses. Its headquarters, including the office of the president, respondent Park, who is chief executive officer of the corporation, are located in Philadelphia, Pennsylvania. In a five-count information filed in the United States District Court for the District of Maryland, the Government charged Acme and respondent with violations of the Federal Food, Drug, and Cosmetic Act. Each count of the information alleged that the defendants had received food that had been shipped in interstate commerce and that, while the food was being held for sale in Acme's Baltimore warehouse following shipment in interstate commerce, they caused it to be held in a building accessible to rodents and to be exposed to contamination by rodents. These acts were alleged to have resulted in the food's being adulterated within the meaning of 21 U.S.C. §§ 342 (a)(3) and (4), in violation of 21 U.S.C. § 331 (k).

Acme pleaded guilty to each count of the information. Respondent pleaded not guilty. The evidence at trial demonstrated that in April 1970 the Food and Drug Administration (FDA) advised respondent by letter of insanitary conditions in Acme's Philadelphia warehouse. In 1971 the FDA found that similar conditions existed in the firm's Baltimore warehouse. An FDA consumer safety officer testified concerning evidence of rodent infestation and other insanitary conditions discovered during a 12-day inspection of the Baltimore warehouse in November and December 1971. He also related that a second inspection of the warehouse had been conducted in March 1972. On that occasion the inspectors found that there had been improvement in the sanitary conditions, but that "there was still evidence of rodent activity in the building and in the warehouses and we found some rodent-contaminated lots of food items."

The Government also presented testimony by the Chief of Compliance of the FDA's Baltimore office, who informed respondent by letter of the conditions at the Baltimore warehouse after the first inspection. There was testimony by Acme's Baltimore division vice president, who had responded to the letter on behalf of Acme and respondent and who described the steps taken to remedy the insanitary conditions discovered by both inspections. The Government's final witness, Acme's vice president for legal affairs and assistant secretary, identified respondent as the president and chief executive officer of the company and read a bylaw prescribing the duties of the chief executive officer. He testified that respondent functioned by delegating "normal operating duties" including sanitation, but that he retained "certain things, which are the big, broad, principles of the operation of the company and had "the responsibility of seeing that they all work together."

At the close of the Government's case in chief, respondent moved for a judgment of acquittal on the ground that "the evidence in chief has shown that Mr. Park is not personally concerned in this Food and Drug violation." The trial judge denied the motion, stating that *United States v. Dotterweich*, 320 U.S. 277 (1943), was controlling.

Respondent was the only defense witness. He testified that, although all of Acme's employees were in a sense under his general direction, the company had an "organizational structure for responsibilities for certain functions" according to which different phases of its operation were "assigned to individuals who, in turn, have staff and departments under them." He identified those individuals responsible for sanitation, and related that upon receipt of the January 1972 FDA letter, he had conferred with the vice president for legal affairs, who informed him that the Baltimore division vice president "was investigating the situation

immediately and would be taking corrective action and would be preparing a summary of the corrective action to reply to the letter." Respondent stated that he did not "believe there was anything [he] could have done more constructively than what [he] found was being done."

On cross-examination, respondent conceded that providing sanitary conditions for food offered for sale to the public was something that he was "responsible for in the entire operation of the company" and he stated that it was one of many phases of the company that he assigned to "dependable subordinates." Respondent was asked about and, over the objections of his counsel, admitted receiving, the April 1970 letter addressed to him from the FDA regarding insanitary conditions at Acme's Philadelphia warehouse. He acknowledged that, with the exception of the division vice president, the same individuals had responsibility for sanitation in both Baltimore and Philadelphia. Finally, in response to questions concerning the Philadelphia and Baltimore incidents, respondent admitted that the Baltimore problem indicated the system for handling sanitation "wasn't working perfectly" and that as Acme's chief executive officer he was "responsible for any result which occurs in our company."

At the close of the evidence, respondent's renewed motion for a judgment of acquittal was denied. The relevant portion of the trial judge's instructions to the jury challenged by respondent is set out in the margin. Respondent's counsel objected to the instructions on the ground that they failed fairly to reflect our decision in *United States v. Dotterweich supra*, and to define "'responsible relationship.'" The trial judge overruled the objection. The jury found respondent guilty on all counts of the information, and he was subsequently sentenced to pay a fine of $50 on each count. The Court of Appeals reversed the conviction and remanded for a new trial.

* * *

The question presented by the Government's petition for certiorari in *United States v. Dotterweich*, and the focus of this Court's opinion, was whether the manager of a corporation, as well as the corporation itself, may be prosecuted under the Federal Food, Drug, and Cosmetic Act of 1938 for the introduction of misbranded and adulterated articles into interstate commerce. In *Dotterweich*, a jury had disagreed as to the corporation, a jobber purchasing drugs from manufacturers and shipping them in interstate commerce under its own label, but had convicted Dotterweich, the corporation's president and general manager. The Court of Appeals reversed the conviction on the ground that only the drug dealer, whether corporation or individual, was subject to the criminal provisions of the Act, and that where the dealer was a corporation, an individual connected therewith might be held personally only if he was operating the corporation as his 'alter ego.'

In reversing the judgment of the Court of Appeals and reinstating Dotterweich's conviction, this Court looked to the purposes of the Act and noted that they "touch phases of the lives and health of people which, in the circumstances of modern industrialism, are largely beyond self-protection. It observed that the Act is of "a now familiar type" which "dispenses with the conventional requirement for criminal conduct-awareness of some wrongdoing: In the interest of the larger good it puts the burden of acting at hazard upon a person otherwise innocent but standing in responsible relation to a public danger. Central to the Court's conclusion that individuals other than proprietors are subject to the criminal provisions of the Act was the reality that the only way in which a corporation can act is through the individuals, who act on its behalf.

* * *

The Court recognized that, because the Act dispenses with the need to prove "consciousness of wrongdoing," it may result in hardship even as applied to those who share "responsibility in the business process resulting in" a violation....The rule that corporate employees who have "a responsible share in the furtherance of the transaction which the statute outlaws" are subject to the criminal provisions of the Act was not formulated in a vacuum. Cf. *Morissette v. United States*, 342 U.S. 246, 258 (1952). Cases under the Federal Food and Drugs Act of 1906 reflected the view both that knowledge or intent were not required to be proved in prosecutions under its criminal provisions, and that responsible corporate agents could be subjected to the liability thereby imposed.

* * *

The rationale of the interpretation given the Act in *Dotterweich*...has been confirmed in our subsequent cases. Thus, the Court has reaffirmed the proposition that the public interest in the purity of its food is so great as to warrant the imposition of the highest standard of care on distributors.

Thus *Dotterweich* and the cases which have followed reveal that in providing sanctions which reach and touch the individuals who execute the corporate mission—and this is by no means necessarily confined to a single corporate agent or employee—the Act imposes not only a positive duty to seek out and remedy violations when they occur but also, and primarily, a duty to implement measures that will insure that violations will not occur. The requirements of foresight and vigilance imposed on responsible

corporate agents are beyond question demanding, and perhaps onerous, but they are no more stringent than the public has a right to expect of those who voluntarily assume positions of authority in business enterprises whose services and products affect the health and well-being of the public that supports them.

* * *

Reading the entire charge satisfies us that the jury's attention was adequately focused on the issue of respondent's authority with respect to the conditions that formed the basis of the alleged violations. Viewed as a whole, the charge did not permit the jury to find guilt solely on the basis of respondent's position in the corporation; rather, it fairly advised the jury that to find guilt it must find respondent "had a responsible relation to the situation," and "by virtue of his position...had...authority and responsibility" to deal with the situation.

The situation referred to could only be "food...held in unsanitary conditions in a warehouse with the result that it consisted, in part, of filth or...may have been contaminated with filth."

Our conclusion that the Court of Appeals erred in its reading of the jury charge suggests as well our disagreement with that court concerning the admissibility of evidence demonstrating that respondent was advised by the FDA in 1970 of insanitary conditions in Acme's Philadelphia warehouse. We are satisfied that the Act imposes the highest standard of care and permits conviction of responsible corporate officials who, in light of this standard of care, have the power to prevent or correct violations of its provisions.

* * *

Reversed.

CASE QUESTIONS

1. Did Park have criminal intent to put adulterated food into commerce? If not, how can Park's conduct be criminalized?
2. To get a conviction, what does the prosecutor have to show, other than that Park was the CEO of Acme and therefore responsible for what his company did or didn't do?

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7.8: Summary and Exercises

Summary

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

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

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

Exercises

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

criminal law." The warrants did not describe the specific crime suspected, nor did the warrants limit the seizure of items solely to Dali artwork or suspected Dali forgeries. Are these search warrants valid?*Center Art Galleries—Hawaii, Inc. v. United States*, 875 F.2d 747 (9th Cir. 1989).

SELF-TEST QUESTIONS

1. Jared has made several loans to debtors who have declared bankruptcy. These are unsecured claims. Jared "doctors" the documentation to show amounts owed that are higher than the debtors actually owe. Later, Jared is charged with the federal criminal offense of filing false claims. The standard (or "burden") of proof that the US attorney must meet in the prosecution is a. beyond all doubt
   b. beyond a reasonable doubt
   c. clear and convincing evidence
   d. a preponderance of the evidence
2. Jethro, a businessman who resides in Atlanta, creates a disturbance at a local steakhouse and is arrested for being drunk and disorderly. Drunk and disorderly is a misdemeanor under Georgia law. A misdemeanor is a crime punishable by imprisonment for up to a. one year
   b. two years
   c. five years
   d. none of the above
3. Yuan is charged with a crime. To find him guilty, the prosecutor must show a. actus reus and mens rea
   b.mens rea only
   c. the performance of a prohibited act
   d. none of the above
4. Kira works for Data Systems Ltd. and may be liable for larceny if she steals a. a competitor's trade secrets
   b. company computer time
   c. the use of Data Systems' Internet for personal business
   d. any of the above
5. Candace is constructing a new office building that is near its completion. She offers Paul $500 to overlook certain things that are noncompliant with the city's construction code. Paul accepts the money and overlooks the violations. Later, Candace is charged with the crime of bribery. This occurred when a. Candace offered the bribe.
   b. Paul accepted the bribe.
   c. Paul overlooked the violations.
   d. none of the above

SELF-TEST AnswerS

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

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8: CONTRACTS

8.1: Introduction
8.2: Formation
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8.4: Assignment, Delegation, and Commonly Used Contracts Clauses
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8.1: Introduction

Learning Objectives

After reading this chapter, you should understand what a contract is, how a contract is formed, the types of law that govern contracts, the elements of common-law contract formation, and defenses to contracts. You will learn about performance and discharge, breach, and remedies. You will also understand important differences between common-law contracts and contracts between merchants under the Uniform Commercial Code (UCC). You will recognize commonly used clauses in contracts and their importance. You will also learn about assignment, delegation, and parol evidence. At the conclusion of this chapter, you should be able to answer the following questions:

- What is a contract?
- How is a contract formed?
- When does common law govern contract formation, and when is the UCC relevant?
- What are the defenses to performance of a contract?
- What does it mean to breach a contract, and what are the consequences of breach?
- What are remedies for breach of contract?
- What common clauses can be used to accomplish certain goals, such as ensuring expediency, limiting liability, or restricting assignment?

Clint Eastwood had a long-term relationship with Sondra Locke. Sadly, the relationship deteriorated and, allegedly, ended on unfriendly terms. The couple never married, but they shared a household for many years, and they worked on many professional projects together. When the relationship ended, Locke sued Eastwood for various causes of action. To settle the case, Eastwood proposed, among other things, that if Locke dropped the lawsuit against him, he would secure a development deal for Locke at Warner Bros. Inc. Locke was not only an actress; she was also a director. No doubt assuming that this deal would advance her professional interests and, at the same time, bring a long-standing personal dispute to an end, Locke agreed. Locke entered into a settlement agreement with Eastwood, and as promised, she contemporaneously entered into an agreement with Warner Bros. The agreement with Warner Bros. had two components. First, it required Locke to submit work that she was interested in developing, before she submitted it elsewhere. Warner Bros. was to accept or reject the work within thirty days. For this part of the contract, Locke would receive $250,000 per year for three years. Second, the contract was a $750,000 “pay or play” deal, which gave Warner Bros. a choice between using Locke’s services as a director and paying Locke a fee. Though Locke did not know this, Eastwood agreed to reimburse Warner Bros. for the cost of this contract if she did not have success in developing her projects or using her director services. Warner Bros. paid the $1.5 million contemplated under the contract, but it did not develop any of Locke’s thirty proposed projects, and it did not hire her to direct any films.

Locke argued that the agreement had been a sham, because Warner Bros. had never intended to make films with her. She also argued that its only motivation for entering into the contract with her was to help Eastwood in settling her earlier claims against him. Locke sued Warner Bros. for a number of claims, including a breach of the implied covenant of good faith and fair dealing, and fraud. She alleged that she was deprived of the benefit of the bargain and that Warner Bros. had no intention of honoring its agreement with her. Warner Bros. won at trial, and Locke appealed.

The California Court of Appeals found that while the creative decisions of Warner Bros. were not appropriate for judicial review, acting in bad faith by refusing to consider the merits of Locke’s proposals was a matter for the courts. The court also noted that even though the contractual sum of money was paid, that alone did not constitute performance under the contract. Part of the value of the contract for Locke was the opportunity to work on projects that would earn additional money and promote and enhance Locke’s career. Moreover, the appellate court found that if Warner Bros. never intended to work with Locke but had entered into the contract solely to accommodate Eastwood, then a lack of good faith might be inferred.*Locke v. Warner Bros. Inc.*, 57 Cal. App. 4th 354 (1997).

What do you think about this case? After all, Locke was compensated the amount of money explicitly contemplated under the contract. Should it matter whether one party acts in good faith or not? We might say that this contract contains all necessary elements to be enforceable, and it looks on its face as if it has been performed. However, a lack of good faith by one party could lead to damages. After the court’s decision, the parties settled for an undisclosed amount.

Contracts are a fundamental part of doing business. A contract is a legally enforceable promise. As you know, breaking promises

is a big deal. Ethical questions arise when promises are broken. For example, what if you promised to mow your elderly neighbor's lawn because you wanted to help him, but then you never got around to doing it? Wouldn't you feel guilty about watching his grass grow into tall weeds?

When the promise is a legally enforceable promise, feeling guilty about breaking the promise is not the only fallout. When a legally enforceable promise is broken, the injured party can seek damages. In contracts, this usually means that the party who breaches the contract must pay the injured party an amount that would make that party whole again. Also, some people disagree about whether breaching a legally enforceable promise—that is, a contract—carries any ethical implications. For instance, if a company decides that it is less expensive to pay damages than fulfill its promise by performing under a contract, it might make the decision to breach based on rational decision making. That is, since it will be less expensive to breach, it makes sense to breach. Others disagree with this approach, pointing out that reliance on promises is an important part of business that provides necessary stability, regardless of whether keeping the promise makes economic sense or not.

If you had a business, would you breach a contract to save money? Why or why not?

Contracts are agreements between two or more parties. Generally speaking, contracts are a form of private law, because the terms of the contract are binding on those parties but not on everyone. The contract represents mutual assent to a bargained-for exchange between parties.

Generally speaking, in the United States parties may enter into contracts for whatever they wish and under any terms that they agree on. In other words, parties may assent to agreements even if those agreements represent bad bargains. However, there are certain external restrictions on our abilities to form contracts. Additionally, certain internal (to the contract) restrictions may exist on our abilities to exercise rights or to engage in other contracts.

Legal restrictions, external to the contract, limit our ability to bargain. For example, if you wanted to hire someone to work for your company, you could not contract with that person to work one-hundred-hour workweeks at twenty-five cents per hour. Even if you could find someone to work under those conditions and even if you both agreed to those terms of the contract, our statutory and regulatory laws prohibit you from entering into a contract with those terms. Such wages would violate minimum wage laws.

There may also be restrictions that are internal to the contract. Imagine that you entered into an employment contract with a company to work for $55,000 per year, plus benefits, and for a term of two years. You might be pretty happy about that. But what if, one month later, another company offered you the same position at its company, but for a salary of $65,000 per year, plus benefits. The better offer does not invalidate your first contract. In fact, in such a case, your first contract would probably contain a noncompete clause that would prohibit you from working in a similar capacity for a specified length of time and geographic area. So even if you decided to breach your first contract to enter into the second, you would be prohibited from doing so under the noncompete clause.

Key Takeaways

Contracts are legally enforceable promises that, if breached, result in compensable damages. Contracts are a fundamental part of doing business, which require not only performance of the terms of the contract but also good faith in dealing. Parties may enter into a contract for any agreement with terms, providing the agreement is legal. Also, restrictions on ability to contract may be external, such as those imposed by law, or they may be internal, such as those imposed by clauses like noncompete agreements.

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8.2: Formation

Learning Objectives

- Find out when the Uniform Commercial Code (UCC) is the appropriate law to apply and when the common law is the appropriate law.
- Learn the elements of common-law contracts.
- Identify the difference between common-law contracts and contracts between merchants.

A contract is a legally enforceable promise. Therefore, it is important to know whether promises made are legally enforceable. You certainly have made many promises in your life. You have probably broken a few promises, too. For example, if you promised your best friend that you would be best friends forever, but then your relationship changed, we might say that is a broken promise. However, you would not be held legally liable to pay damages for breaking that promise. On the other hand, if you promised your bank that you would make payments to it in exchange for the bank loaning money to you to purchase a car, and if you broke that promise by failing to pay as scheduled, then you have broken a legally enforceable promise. The bank could seek damages from you to make itself whole again. What is the difference between these two promises? Why would you have to pay damages to the bank but not to your former best friend? More specifically, why is one considered a breach of contract and the other simply a broken promise?

This section explores contract formation. We can examine the elements of formation to determine whether the contract is valid or whether it suffers some deficiency that renders it not legally enforceable.

In the United States, two primary sources of law govern our contracts: the common law and the Uniform Commercial Code. The Uniform Commercial Code (UCC) Article 2 governs contracts between a merchant and the sale of goods. Essentially, the UCC contains two sets of rules for contracts. One set involves rules for everyone, and the other set involves rules for merchants. In this section, we will explore the UCC as it applies to merchants. Chiefly, we will examine how the UCC requirements differ from common law in contract formation

However, we will first address common-law contracts. Common law governs contracts for services as well as contracts not otherwise governed by the UCC. It is important to recognize the elements of common-law contract formation because they are more stringent than the requirements for formation between merchants under the UCC. If all elements of common-law contract formation do not exist, then the contract may be void or voidable.

The elements of common-law contract formation include offer, acceptance, and consideration. Offer and acceptance together form mutual assent. Additionally, to be enforceable, the contract must be for a legal purpose and parties to the contract must have capacity to enter into the contract.

An offer gives power of acceptance to another party, and it includes the agreement's essential elements, which must be definite and certain. For example, if an offerer says to you, "I offer to sell you my scooter for four hundred dollars," then that offer is valid. It contains the price, the person to whom the offer is made, and the object of the offer (i.e., the scooter). It creates a power of acceptance in you, the offeree.

Importantly, in common-law contracts, the acceptance must be a mirror image of the offer to constitute valid acceptance. This means that the acceptance must be precisely the same as the offer. If the acceptance is not precisely the same, then it will fail to meet the requirements of an acceptance, and it will not constitute a valid element of formation in contract. To accept the offer, the offeree could say something like this: "I agree to buy your scooter for four hundred dollars." If a counteroffer is made, then that would not be acceptance, because the counteroffer would not be a mirror image of the offer itself. So, for example, if the offeree said, "I agree to buy your scooter for three hundred dollars," that would not be an acceptance. In fact, a counteroffer is a rejection of the offer. Once an offeree rejects an offer—either outright (e.g., by declining to accept) or through counteroffer, the offerer is free to walk away from the failed negotiation. In this example, he no longer has to sell his scooter at all, not even if the offeree changes his mind and agrees to pay four hundred dollars. Likewise, if the offerer revokes an offer before the offeree accepts, then the power of acceptance has been withdrawn by that revocation. The offerer would no longer have to sell the item originally offered. If the offerer wished to limit the time that an offer was valid, he could do so by limiting the time that the offer may be accepted. If the offer is not accepted during that time, then the offerer is not required to honor any acceptance that is made after expiration of the offer.

What if you saw an advertisement for a scooter for sale at a local shop? Perhaps the advertisement looked like this:



Figure 8.2.1

Do you think that this advertisement should create the power of acceptance in you, a potential customer? The fact is that an advertisement is not an offer. It is simply an invitation to bargain. Advertisements are requests for people to make offers. This places the power of acceptance on the merchant, who is free to reject offers or to choose to whom he sells. Of course, certain statutory protections exist today to protect consumers against unscrupulous merchants who might engage in unethical behavior, such as bait-and-switch or false advertising, or race-based denial of services or refusal to contract. Specifically, consumer protection statutes and civil rights statutes, respectively, would protect consumers in such circumstances.

If an offer is valid, then the acceptance must be a mirror image, as mentioned previously. A bilateral contract is a contract in which both parties make a promise. The previous example is an example of a bilateral contract. The following is a promise for a promise:

The offerer says, “I offer to sell you my scooter for four hundred dollars.”

The offeree replies, “I agree to buy your scooter for four hundred dollars.”

Specifically, it is a promise to sell the scooter in exchange for a promise to buy the scooter for four hundred dollars. Since this is a promise for a promise, then this is a bilateral contract.

A unilateral contract is one in which the accepting party may only accept through an action. Here is an example:

The offerer says, “I will sell this scooter to the first person who puts four hundred dollars cash in my hands.”

The offeree says nothing but places four hundred dollars cash into the offeror’s hands.

This is a promise for an action. Specifically, it is a promise to sell the scooter in exchange for the action of placing four hundred dollars cash into the offeror’s hands.

Common-law contracts can be either bilateral or unilateral.

Additionally, all common-law contracts must contain valid consideration. This means that there must be a bargained-for exchange of acts or promises, and both parties must incur new legal detriment or obligations as a result of the contract. Imagine that you have accepted a new position with a company. You have a valid employment contract that you’ve successfully negotiated prior to beginning work. All terms of the contract are valid, and both parties are bound to the contract. Basically, this means that you have agreed to work for a specified period of time, and your employer has agreed to compensate you with a specified salary and benefits in exchange for your work. So far, so good, right?

Now, imagine that during your first week, your boss appears in your office and asks you to sign a new contract that, in essence,

is a noncompete agreement. This means that your employer now wants you to sign a new contract agreeing not to compete with the company if you decide to terminate your employment arrangement. The employer wants you to make this promise, but the employer does not offer anything additional in return. For the purposes of this example, let's say that you sign the new agreement. Is this new agreement valid and binding on you? Probably not. Why? Because the company has not suffered any new legal detriment or obligation as a result of the contract. You have agreed to refrain from competing with the company if you leave, but the company itself has not given you anything in return for your promise. To make this contract binding against you, your employer should have provided consideration. For example, it could have asked you to sign the noncompete agreement in consideration of an additional one thousand dollars of salary per year. Then, the contract would have consideration and it would have a much greater chance of being found to be valid. Better yet, the company should have negotiated the noncompete agreement along with your original contract before you assumed your new position.

Let's continue our example of an offeror who offers to sell his scooter for four hundred dollars. He says, "I offer to sell you my scooter for four hundred dollars." If you reply, "I agree to buy your scooter for four hundred dollars, if I don't find one that I like more," then that does not constitute valid consideration. This is because you have placed a condition on the consideration. In essence, you have made what appears to be a promise to do something, but instead of being a promise, it is only an illusion of a promise. This is called an illusory promise, and it does not constitute valid consideration. There is no legal detriment to you here, because you might find a scooter that you like more than the one offered by the offeror. You have a way out. A legal detriment is a detriment (or burden or obligation) that is legally enforceable. You cannot "get out" of the promise without suffering legal detriment. The other party must be able to rely on the promise for it to constitute valid consideration. The thing bargained for can be an act or a promise (either to do something or to refrain from doing something.)

Additionally, for a contract to be valid, the subject matter of the contract must be for a legal purpose. If a distributor of illegal drugs hires a pilot to fly his illegal cargo to a particular place in exchange for payment, this is a contract for an illegal subject matter. If the drug dealer fails to honor his agreement to pay, or if the pilot fails to honor his agreement to transport the cargo, neither aggrieved party will find a remedy in our courts, even if the elements of contract are all present and perfectly formed.

Moreover, the parties to contract must have capacity to enter into the contract for its terms to be enforceable against them. Adults of sound mind have capacity. Minors lack legal capacity, but they may enter into contracts that they may cancel at their sole option. In other words, a minor who enters into a contract with a party who has capacity may void the contract, but the other party may not. This means that any contract with a minor is voidable by the minor under the infancy doctrine.

Let's compare common-law contract formation with UCC contract formation. Recall that common law governs contracts for services and contracts not governed by the UCC. Article 2 of the UCC governs the sale of goods, which is defined by §2-105 and includes things that are moveable, but not money or securities. It does not include land or houses. Contracts between merchants are also governed by article 2 of the UCC. Generally speaking, §2-104 defines a merchant as a person who deals in goods or holds himself out as having special knowledge or skill regarding the practices or goods that are the subject of the transaction. Since contracts law is a state law issue, each state can have different laws related to contracts. The UCC seeks to provide uniformity to contracts law among the different states. However, like other uniform laws, the UCC does not become a law until state legislatures adopt it as law. All fifty states have adopted some version of the UCC.

As you can imagine, contracts between merchants do not always contain offers that include definite terms, and acceptances are not always mirror images. Merchants typically place a purchase order when they wish to purchase materials, and the seller often sends an invoice with the order when it ships. Merchants frequently use boilerplate language in their individual purchase orders and invoices. Obviously, not every merchant's contract will contain the same language as those of other merchants. This can lead to discrepancies between terms that would be fatal in common-law contract formation, otherwise known as battle of the forms. However, the UCC provides more flexibility in contract formation than exists in common-law contracts, thereby accommodating the reality of business practices. The requirements for common-law contract formation would be too burdensome for merchants. Can you imagine if every merchant had to issue offers with definite terms and receive mirror image acceptances for every item that it sold or purchased to have valid, enforceable contracts? Such a burden might cause commerce to come to a screeching halt. Or it might lead to many contracts disputes.

The UCC also embodies some elements of the Statute of Frauds. The Statute of Frauds requires certain types of contracts to be in writing to be enforceable. Specifically, it requires contracts to be in writing for goods priced at five hundred dollars or more *and* signed by the defendant, for those contracts to be enforceable. Other important types of contracts relevant to business that must be in writing and signed by the defendant to be enforceable include contracts for any interest in land, promises to pay the debts of another, and contracts that cannot be performed within one year. The types of contracts that are contemplated by the Statute of Frauds but are not captured by the UCC are often embodied in state statutes. The peculiar name—the Statute of Frauds—is derived from its early incarnation in seventeenth-century England, when a statute was passed by parliament to reduce or prevent fraud in property transactions and other important civil matters.

Of primary concern to students of business are the differences between common-law contracts and the UCC. When analyzing a contracts issue, identification of the type of law that governs the contract should be addressed first. This is because you cannot know which rule applies unless you know which type of law is applicable.

The primary differences between common-law contracts and the UCC are in the UCC's relaxation of various common-law contract formation requirements. See Table 6.1 "Differences between Contract Formations by Type of Law" for a comparison between common-law and UCC contract formation requirements. When a battle of the forms ensues between merchants, for example, the conflicting terms are not fatal to the contract. This is a major departure from the mirror image rule required by common-law contracts. For the UCC, the primary issue is whether the parties intended to enter into a binding agreement. New or additional terms included in an offer will become part of the contract on acceptance. Terms that conflict with each other will "fall out" of the contract and be replaced by UCC gap fillers, which can create the terms of the contract. Likewise, terms that are left open will be filled in. Gap fillers are terms provided by the UCC, and they can be inserted into a contract when those terms are not definite. While prices, delivery dates, warranties, and other terms can be "filled in" by the UCC gap fillers, quantity cannot. Quantity, therefore, is an essential term that must be specified in the contract for it to be binding.

Table 6.1 Differences between Contract Formations by Type of Law

UCC	Common Law
Any manner that shows agreement to contract (e.g., words, actions, writing)	Mirror image a
Quantity term required; other terms may be filled in with gap fillers	Essential term
Contracts between merchants; contracts for sale of goods priced at $500 or more	Contracts for s

Key Takeaways

A contract is a legally enforceable promise. Common law and the UCC are different sources of contract law. Common law is the appropriate type of law for service contracts and contracts that do not fall under the UCC, like real estate contracts. The UCC governs contracts involving the sale of goods with a price of five hundred dollars or more and in contracts between merchants. Common-law contract formation requires a valid offer, acceptance, and consideration. The parties must have capacity, and the subject matter must be a legal purpose. The UCC relaxes formation requirements by allowing the use of gap fillers for undefined or conflicting terms and by allowing a contract to be formed by any manner that shows agreement to contract. Quantity is a required term for contracts governed by the UCC.

Exercise 8.2.1

1. If a contract was not entered in good faith, do you think that fact alone should matter? Consider *Locke v. Warner Bros. Inc.*, which was discussed in the introduction to this chapter. All essential elements of the contract appear to have existed, and the parties performed as required by the wording of the contract. How can lack of good faith be shown?
2. Has anyone ever broken a promise to you? Were those promises legally enforceable promises? Why or why not? Be sure to analyze the agreement by checking to see if all elements of contract formation were present. Remember to first determine whether the promise was one governed by the UCC or by common law.
3. What are the dangers inherent in making a counteroffer? Imagine that you really wanted to sell your house. You receive an attractive offer, but you wondered whether you might be able to sell the house for a little more money. What types of things should you think about before submitting a counteroffer?

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8.3: Performance and Discharge, Breach, Defenses, Equitable Remedies

Learning Objectives

- Learn what constitutes performance.
- Understand what it means to discharge obligations in a contract.
- Explore different standards of performance.
- Examine breach.
- Explore defenses to breach.
- Learn about equitable remedies.

A contract is an enforceable promise. When the promise is fulfilled, then the contract terms have been satisfied. This means that the parties are discharged from the contract, because they have already fulfilled their legal duties under it. That is, they have satisfactorily performed their obligations under the contract. Performance simply means undertaking the legal duties imposed on us by the terms of the contract. This is certainly what parties hope for when they enter into a contract—the successful execution of the terms of the contract and subsequent discharge from it.

But how do we know whether the contract terms have been performed? Sometimes it's easy to determine. For instance, if I offer to sell you my scooter for four hundred dollars, you agree to buy my scooter for four hundred dollars, and we exchange those items, then we have fulfilled our obligations under the terms of the contract. We formed a contract, we fully performed our obligations under it (known as complete performance), and we are subsequently discharged from further duties arising under that contract.

In other cases, whether a party has performed can be trickier to determine. For example, imagine that you hire a builder to construct a new home for you. You specify all dimensions of the home, as well as your chosen building materials. Certainly, this would be a very detailed contract. Imagine that all essential elements have been determined and that the contract is valid. In short, the builder agrees to build your specified home, and you agree to pay the builder the agreed on price. Imagine that everything goes according to plan. When your home has been constructed, you visit it for the first time. To your dismay, you see that the foyer has been tiled in red ceramic, even though you clearly specified—and the contract clearly reflected—that the foyer should be tiled in blue ceramic. However, on your further inspection, every other item specified in the contract has been completely performed. Would we say that the builder has performed his duties under this contract? The item at issue is the problem with the foyer tile. Does this error rise to breach? More importantly, does this excuse your obligations under the contract to pay the builder for his work?

When a party fails to perform under the terms of the contract without a legally justifiable reason, the party is said to be in breach of the contract. However, in a service contract—such as a service to build a house—the standard of performance is substantial performance. This means that the performing party acted in good faith and conveyed enough benefit of the contract to the other party so that the other party can use the benefit for its intended purpose, and the defects arising under the contract may be remedied by money damages. A material breach in a service contract is when a party has not substantially performed under the terms of the contract. A minor breach is when the party has substantially performed but has not *strictly* performed. In our example, installation of the red tile in the foyer would not rise to material breach, because presumably, the builder acted in good faith, he produced a house that is capable of being used for its intended purpose, and the defects (the red tile) can be remedied through monetary damages. They simply need to be replaced by blue tiles. This was a minor breach. If this were your contract, you would have to pay the builder as required under the contract, less the cost of replacing the tile.

Consider the firing of Texas Tech's head football coach, Mike Leach, in "Hyperlink: Coach Mike Leach" to practice your analytical skills. Try to identify what additional information you would need to determine whether substantial performance exists, or whether the contract has been materially breached.

Sometimes, substantial performance is not adequate. Adherence to a strict performance standard requires express terms in the contract to that effect and circumstances where such a high standard is reasonable. In our scooter example, if you tried to give the offeror three hundred dollars in cash and one hundred dollars in postage stamps, then that would most likely not satisfy the terms of the contract. You might recall that the contract was a bargain for a scooter in exchange for four hundred dollars. Here, strict performance makes sense and is reasonable.

Performance to the standard of personal satisfaction can be enforced if the contract expressly requires it. This means that the performance under the contract is scrutinized subjectively, either by one party to the contract or by a third-party beneficiary specified in the contract. If the subject of the contract is something for which approval is dependent on someone's subjective opinion, like personal taste, then assessment can be made on a subjective standard providing this standard is clearly specified in the contract. For example, if you owned a piano bar, and you wished to hire a truly inspired pianist for entertainment, you might enter into a contract with a pianist subject to a personal satisfaction standard. Even if that person could tickle the ivory flawlessly, you might decide that his or her music is technically accurate but not truly inspired. Providing that your contract with the pianist allows for personal satisfaction to be the standard of performance, you may terminate that contract based on his or her failure to meet the personal satisfaction standard. This standard is unlike the substantial performance standard, which requires an objective assessment based on the reasonable person standard. Referring again to "Hyperlink: Coach Mike Leach", which standard appears to be controlling Texas Tech's decision to terminate Coach Leach's contract—personal satisfaction or substantial performance? Which standard is appropriate for a contract for coaching services?

Hyperlink: Coach Mike Leach

Head football coach Mike Leach of Texas Tech was fired for breach of contract. He had recently signed a $12.7 million contract for five years, and he had been named by the Associated Press as the Big XII Coach of the Year in 2008. However, that didn't stop Texas Tech from firing him, citing breach of performance as the reason for the termination. Under the terms of his contract, he was to "assure the fair and responsible treatment of student-athletes in relation to their health, welfare, and discipline." Allegedly, Coach Leach forced a student athlete to stand in a shed after the athlete was diagnosed with a mild concussion. Leach's supporters argue that the "shed" was a comfortable garage-like room with a cooler and a fan and that Coach Leach was simply having the player stand inside, out of the sun, in accordance with medical orders. Others argue that this was a sadistic punishment that was inappropriately levied against an injured player. Was Leach being cruel, or was he being protective of his charge in accordance with his contract terms?

Underlying this controversy are allegations that the firing occurred because Leach interviewed with another university unbeknownst to Texas Tech and because he has a colorful personality that might offend some people. For instance, he allegedly blamed his players' "fat little girlfriends" for distracting them to their defeat against Texas A&M.

Coach Leach was fired just before receiving an alleged $800,000 contractual bonus.

Check out the story here:

http://www.cnn.com/2009/US/12/31/texas.tech.leach/index.html?iref=allsearch

Check out the video of the story here:

http://sports.espn.go.com/ncf/bowls09/news/story?id=4781981

Watch Coach Leach here:

http://sports.espn.go.com/ncf/bowls09/news/story?id=4781981

Watch speculation about Coach Leach's likelihood of being hired here:

http://sports.espn.go.com/ncf/bowls09/news/story?id=4781981

See the exercises in this section for related questions and discussion.

As mentioned previously, when the promises in a contract have been fulfilled based on the appropriate standard—substantial performance, strict performance, or personal satisfaction—then the parties are discharged. However, when a material breach occurs, the injured party may bring a claim for damages. But that isn't necessarily the end of the story. The breaching party may have a valid reason for breaching the contract. These valid reasons are known as defenses to contract. These defenses include formation problems, lack of capacity, illegality of subject matter, impossibility, duress, unconscionability, undue influence, violation of the Statute of Frauds requirement that certain types of contracts must be in writing to be enforceable against the defendant, exceeding the statute of limitations, mistake, misrepresentation, fraud, commercial impracticability, and frustration of purpose. Bankruptcy discharge is a permanent legal excuse from performance, and it will discharge obligations that are dischargeable by law if the debtor successful fulfills his obligations under the bankruptcy. Obligations that are not dischargeable

by law will not be permanently discharged by a bankruptcy. However, during the bankruptcy, the performance of contract terms requiring payment of debt incurred prior to filing the bankruptcy petition is suspended by the court until the bankruptcy is terminated either by successful completion of the bankruptcy or by dismissal of the case.

Formation problems in common-law contracts relate to whether the offer, acceptance, and consideration were valid. For example, if the offer did not contain the essential terms in definite and certain form, then that offer will not be valid. If I offered to sell you my house for a fair price, it would not be a sufficient offer because the price term is an essential element, and in this offer it is vague. To say that a house will be sold "for a fair price" is not specific. Likewise, in a common-law contract, if the acceptance is not a mirror image of the offer, then the acceptance will not be valid. Similarly, if consideration does not firmly commit the parties to the deal, then consideration will fail, as is the case with an illusory promise. For example, if I offered to sell you my house for $150,000, and you agreed to buy it "if you like it," then that is not a firm commitment. Consideration will fail, and the contract has not formed. As a practical matter, how can this defense be used? The defendant simply needs to show that the contract was never formed in the first place, due to one or more deficiencies in formation. Keep in mind, however, that if the Uniform Commercial Code (UCC) is the relevant type of law, formation is much simpler than in common law. For example, all essential elements do not need to be stated in definite and certain terms (but quantity must be stated), and acceptance does not need to be a mirror image of the offer. Accordingly, in contracts in which the UCC is the relevant type of law, this defense can be more challenging to successfully mount.

Sometimes when all elements of the contract are not present, the court will enforce the promise through an equitable remedy to avoid a perceived injustice that would occur if the contract failed based on a formation defect. Quasi-contract and promissory estoppel are two types of equitable remedies that a court may impose. When detrimental reliance is found, an equitable remedy can substitute for consideration. This allows the court to enforce the terms of the "contract," even though, technically speaking, there was no contract to begin with.

Quasi-contract is determined when one party will receive a benefit from the other unjustly (unjust enrichment), and the party who tendered the benefit reasonably expected to be paid for it. The party who received the benefit knew that the other party reasonably expected to be paid. For example, imagine that your neighbor hired painters to paint his house, but the painters accidentally appeared at your house to work. Instead of sending them away, you decided to let them paint your house, but you did not tell them that they were at the wrong house. At the end of the job, they demanded payment. You point out that they never had a contract with you. While this would be true in fact, the issue is that you would be unjustly enriched by their painting of your house if you were not made to pay. Additionally, you knew that the painters would reasonably expect to be paid for their services, and you did nothing to stop them. This would be a good case for a court to impose the equitable remedy of quasi-contract. The damages awarded in such case are called quantum meruit, which means "as much as is deserved." The painters will receive the value of their services in damages. Compare this situation with one in which you were on vacation when the painters painted your house. You knew nothing of their presence. In such a case, quasi-contract would not be imposed as an equitable remedy because you were not aware of their presence. In fact, you would have a potential claim against the painters for interfering with your property and entering your land without your permission. Promissory estoppel is another equitable remedy. It is imposed on parties when one party detrimentally relied on another's promise, and to avoid injustice, the enforcement of the promise is required. Like quasi-contract, when promissory estoppel is used, there is some formation problem with the contract so, technically speaking, no contract exists.

The remaining defenses discussed in this chapter are relevant if the contract is valid. That is, there are no formation problems. For example, if a party lacks capacity to enter into a binding contract, that can be used as a defense. When people lack the mental ability to understand, they lack capacity. Sometimes, it may *seem* that someone understands, even though he or she might actually lack legal capacity. This is the case with minors. Though some may certainly understand the terms of a contract, they lack the legal capacity to be bound to it. That means that they can disaffirm the contract if they wish. Likewise, someone who suffers from a temporary or permanent cognitive defect lacks capacity to be bound to a contract. This may be the case with an infant, a person who suffers from dementia, or a person who has other profound cognitive or mental impairment. Use of alcohol or drugs may impair capacity, but the courts are reluctant to find this as a convincing defense, particularly if the person voluntarily imbibed in the alcohol or drug use themselves. If they were involuntarily drugged, however, then lack of capacity can be a good defense. If someone does not read or speak the language in which the contract is written, that can also indicate a lack of capacity.

If the subject matter of a contract or the terms of the contract are illegal, then the contract may be void at the outset, or it may become void if the subject matter or the terms of the contract become illegal after the contract is formed. The former case can be illustrated by imagining a contract for the production of illegal drugs. A defense to performance is that the contract itself concerns an illegal subject matter. A court will not step in to such a contract to enforce its promises.

The latter case of illegality of the terms of the contract is an example of impossibility as a defense. Impossibility is a defense that can be used when performing the contract has become truly impossible. For example, if you entered into a contract to do

business in a country that was subsequently placed on a no-trade list by the federal government, then you would be excused from performing your obligations under that contract, because it would violate federal law for you to perform as promised. It would be impossible, and impossibility would be a valid defense. Sometimes impossibility does not involve the legality of the subject matter or the terms of the contract. Instead, it might simply be a matter of the destruction of the subject matter of the contract. In our scooter example, imagine that before the transaction was completed, the scooter was crushed by the trash collector by accident. The subject matter of the contract was destroyed, and so it would be impossible for the offerer to perform. The offerer would not need to find another scooter to sell to fulfill the obligations under the contract. Instead, he or she would use the defense of impossibility.

Another defense to contract performance is duress. If a party suffers from duress when entering the contract, that party will have a valid defense. Duress means that the party had no other reasonable alternative but to enter into the contract. The party was coerced into entering into the agreement. For example, imagine that you entered into a contract for automobile insurance. Part of your insurance contract requires your insurance company to defend you in the event of a lawsuit arising from a traffic accident. Imagine that you are involved in a traffic accident and your insurance company refuses to defend you. This is bad news, because you will still need to mount a defense. You will probably expend a great deal of money defending yourself, not to mention trying to launch a complaint against your insurance company for breach of contract. After spending all of your savings and borrowing just to pay your bills, imagine that your insurance company comes to you with an offer to pay you fifty thousand dollars if you sign a waiver that it has no liability to you. You will probably sign that waiver and take the money. Why? Because you have no reasonable alternative. This is an example of economic duress, and it is likely that no court would enforce the waiver for the benefit of the insurance company given such facts. The insurance company forced you into signing an agreement with it that you would not have signed if you had any other reasonable alternative.

Unconscionability is a defense used when the contract contains markedly unfair terms against the party with less bargaining power or sophistication than the party who created the terms and induced the other party to sign it. For example, imagine a biotech company discovering a cure for cancer from a plant growing on the private lands of an indigenous people. Imagine that the indigenous people did not understand the importance of the discovery, and they did not understand the value of it. If the biotech company offered to pay for the absolute and complete rights to the plant with ten dollars and a bag of flour, that contract might be said to be unconscionable.

Undue influence is a defense that can be used when one party ceases to be able to exercise his or her free will due to the superior power and influence exerted over that party by the other. For example, imagine an elderly person who is completely isolated from social contact due to poor health and remote living conditions. That person might be quite lonely and eager for company. Say that an unscrupulous person entered that elderly person's life and exerted influence over that person so that the elderly person really could not exercise his free will any longer. If, consequently, the elderly person entered into a contract with the other party to transfer all of his wealth to that person, we might say that this is a case of undue influence. How might this happen? Maybe the unscrupulous intruder is the only human contact that the elderly person has, and maybe he or she led the wealthy elderly person to believe that the only way to salvation is by handing over his assets.

Remember, too, that the Statute of Frauds requires certain contracts to be in writing and signed by the defendant to be enforceable against the defendant. If those types of contracts are not in writing, that can be used as a defense to performance. Contracts for any interest in land, in consideration of marriage, and to pay the debts of another that cannot be performed within one year and contracts for the sale of goods with a price of five hundred dollars or more are all examples of contracts that are required to be in writing to be enforceable according to the Statute of Frauds. If a contract exists for these items, but the contract is not in writing, it may be performed. However, if there is a dispute arising under the contract, it will not be enforced because it violates the Statute of Frauds requirement for a writing.

The statute of limitations is an affirmative defense that can be raised by a defendant to argue that the complaint is being brought too late, by law, to do anything about it. This means that if a dispute arises under a contract, then the plaintiff must bring a complaint concerning that dispute within a certain time period. Every state has different statutes of limitations for different types of disputes. Contracts statutes of limitations range from three to ten years, depending on whether the contract was oral or written, and depending on the jurisdiction.

Mistake is rarely a successful defense to contract, but it is a defense nonetheless. Mistake does not mean bad bargaining. After all, we have the freedom to bargain badly, and the courts will not step in to save us if we do so. For instance, if you agree to buy a house for $170,000, but the house is only worth $150,000, you may have bargained badly, particularly if the seller did not deceive you in any way. The court will not step in to rewrite the contract or allow you to use mistake as a defense to excuse your performance. Indeed, the court will enforce the terms of the contract if it is a valid contract. Mistake refers to something that is truly a mistake either by one party or by both. If the parties to a contract truly make a mistake with respect to essential terms of the contract, then that can be used as a defense to performance.

Misrepresentation and fraud are also defenses to contract. Misrepresentation is when a party makes a false statement that induces the other party to enter into the contract. Fraud is a closely related concept, and it simply means that one party has used deception to acquire money or property. Often, unscrupulous salespeople will commit fraud or misrepresent the subject matter of the contract in such a way that the other party will enter into the contract. However, fraud and misrepresentation both may be used as successful defenses in such circumstances.

Commercial impracticability is a defense that can be used when fulfilling a contract has become extraordinarily difficult or unfair for one party.

Frustration of purpose is when the contract has become essentially worthless to one party, though the event giving rise to that state was nonexistent or unknown to both parties to the contract at formation.

Finally, sometimes a party to a contract files for bankruptcy protection. When that party is required to pay a debt that was incurred before the bankruptcy was filed, that duty is suspended temporarily or permanently when the bankruptcy is filed through the court's automatic stay. In other words, the debt does not have to be paid during the course of the bankruptcy. At the conclusion of the bankruptcy, if the debtor is successful in bankruptcy and if the contract obligation is a dischargeable debt, then the debt will never have to be paid. The debt is, in fact, discharged. Bankruptcy is a defense to performance of contract for debtors who file for bankruptcy protection.

Remedies for breach of contract are typically monetary damages. Expectation damages, including compensatory and consequential damages, can be recovered. However, consequential damages may not be speculative. Indeed, they must be foreseeable to both parties at the time of the contract formation to constitute damages by breach. Specific performance might be required under certain types of contracts, such as in contracts for land. For example, in contracts for real property, the assumption is that land is unique. Therefore, monetary damages are not adequate, because "replacement" land cannot be found that would be like the land that is the subject of the contract. Importantly, specific performance is not an appropriate remedy for service contracts, given the prohibition against involuntary servitude in the Thirteenth Amendment to the U.S. Constitution. Finally, it is important to note that on breach, the injured party has a duty to mitigate his damages. This means that he must avoid damages by making reasonable efforts to do so. If a tenant breaches a contract by moving out of his apartment before the lease is over, the landlord will be able to recover damages from that tenant for breaking the lease (i.e., breaching the contract). However, the landlord also has a duty to mitigate those damages by trying to find another tenant.

Key Takeaways

A contract is an enforceable promise. Parties to the contract must perform according to the relevant standard—substantial performance for most service contracts, personal satisfaction, complete performance, or strict performance. Once parties have performed, they are discharged from further obligations under the contract. Failure to perform according to the requisite standard is a breach, which is a compensable injury. A breach may be minor or major. Several defenses exist to breach of contract.

Exercise 8.3.1

1. Referring to "Hyperlink: Coach Mike Leach", what additional information would you need to determine whether Coach Leach's services fell below substantial performance and were a material breach or whether he substantially performed his contract so that he did not materially breach it? Should coaching services be evaluated based on substantial performance or personal satisfaction? Why?
2. In international business, it is very common for parties to contract not to read or speak the same language. If someone sought to enter into a contract with you, but that party could not read the language in which your contract was written, should you enter into that contract with that person? How can this problem be overcome so that both parties can form a legally binding contract with each other?

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8.4: Assignment, Delegation, and Commonly Used Contracts Clauses

Learning Objectives

- Learn about assignment and delegation.
- Examine novation.
- Explore restrictions on assignment, exculpatory clauses, noncompete clauses, mandatory arbitration clauses, acceleration clauses, and liquidated damages clauses.
- Explore the parol evidence rule.

What if you formed a contract with a rock 'n' roll band for its services? Specifically, you wanted the band to play at your nightclub, because you thought that your customers would enjoy the band enough to pay to see it perform. You hired this specific band because you heard that it drew large crowds of paying customers. Imagine your surprise when, as you anticipate the band's performance, you discover that another band—one you have never heard of—has come to play instead of the original contracting band. On inquiry, you learn that the original band transferred its duties to perform to a lesser-known band. Can it do that?

Contract elements—the terms of the contract—are important. They may, among other things, foreclose your ability to bring a complaint in court, they may render you unable to be hired in your profession (at least within certain boundaries), or they may limit liability to a party that had a role in causing injury to you. If you are not aware of these elements, then you may face an unpleasant surprise if you act in a way contrary to the restrictions imposed by those terms. Likewise, contracts possess certain qualities that prohibit parties from acting in certain ways, unless those qualities are expressly waived. This section identifies common properties of contracts, as well as commonly used elements of contracts. If you are negotiating a contract and you do not like a term, then you should not agree to it. In law, there is a presumption that you have read, understood, and agreed to each and every term of any contract to which you are a party. Arguing that you did not understand or that you did not approve of a particular term in the contract will not be a valid excuse to performance. You should know what you can expect when you enter into a contract. Are you getting the band that you wanted to hire to play in your nightclub, or are you really getting any band that the original band happens to transfer its duties to?

As a preliminary matter, it is important to realize that contracts are, by law, assignable and delegable. This means that the rights conveyed by the contract may be transferred to another party by assignment, unless an express restriction on assignment exists within the contract, or unless an assignment would violate public policy. Likewise, the duties imposed on a party may be transferred to another party by delegation, unless the contract expressly restricts delegation, or there is a substantial interest in personal performance by the original party to the contract, or if delegation would violate public policy. In the case of a band hired to perform at a nightclub, an argument could be made that the original band cannot delegate its duties under the contract because there was a substantial interest in personal performance by the original band. This would render the contract nondelegable. To be on the safe side, your contract with that band should have had a clause expressly prohibiting delegation.

Many students have seen restrictions on assignment in the form of no-sublease clauses in leases with landlords. Do you have a no-sublease clause in your lease? If so, that is a restriction on assignment. This clause is necessary to prevent you from assigning your rights under the lease—your rights to inhabit the premises—to another party. It is necessary for the landlord to include that provision expressly if she wishes to prevent you from subleasing the unit, because there is a presumption in law that assignment is permitted unless it is expressly prohibited by the contract or unless the assignment would violate public policy. Since it is unlikely that letting someone else live in your housing unit in your absence would violate public policy, then the landlord must expressly prohibit the assignment within the original contract if she wishes to prevent tenants from subleasing. A landlord may have a very good reason to wish to prevent subleasing; she may wish to ensure that each tenant is creditworthy prior to allowing the tenant to live in the property.

Note that in delegation and in assignment, the original contracting party is not "off the hook" if it transfers its duties or rights to another party. For instance, if subleasing was not prohibited, and the new tenant assumed the rights and duties imposed by the original contract, the original party to the contract is still liable for the payment of rent. If the subleasing tenant does not pay the rent, the original party to the lease is still liable. The way to excuse oneself from this liability is to form a three-way novation with the original party and the new party, thereby excusing the exiting party from future liability arising under the contract. A novation is essentially a new contract that transfers all rights and duties to the new party to the contract and releases the previous party

from any further obligation arising from the original contract.

Restrictions on assignment or delegation are not the only common elements that can be found in contracts. For example, you have probably encountered exculpatory clauses. An exculpatory clause is an express limitation on potential or actual liability arising under the subject matter of the contract. In short, exculpatory clauses are often employed when risk of injury exists. They seek to limit one party's liability to another. You most certainly have signed exculpatory agreements or contracts containing exculpatory clauses if you have participated in any potentially dangerous activity at a club or with an organized group that could incur liability from injuries suffered by its patrons or members. For example, if you join a kayaking club, you will most likely be asked to sign such an agreement to "hold harmless" the club in the event of any accident or injury. However, despite the existence of an exculpatory clause, liability will not be limited (that is, the liability limitations will be unenforceable) when the party who would benefit from the limitation on liability acted with gross negligence, committed an intentional tort, or possessed greatly unequal bargaining power, or if the limitation on liability violates public policy. Imagine that you signed an agreement to engage in kayaking activities with a kayaking group, but the leader of the group battered you with her oar because she was angry with you for mishandling your kayak. Since battery is an intentional tort, the exculpatory clause will not protect the kayaking organization from liability it incurred through the actions of its employee.

Another common contract element that you may have encountered is a noncompete clause. A noncompete clause attempts to restrict competition for a specified period of time, within a certain geographic region, and for specified activities. Noncomplete clauses are generally valid against the party who signed it if the time, place, and scope are reasonable. These are very common clauses in employment contracts, particularly where the duties involved in employment are likely to involve trade secrets or other proprietary information that the company wishes to protect.

A mandatory arbitration clause is very common in consumer contracts and employment contracts. You have certainly subjected yourself to the restrictions imposed by these clauses if you have signed a contract for a credit card. Mandatory arbitration clauses require parties to a contract that contains such a clause to submit to mandatory arbitration in the event of a dispute arising under the contract. Mandatory arbitration clauses frequently foreclose any possibility of appealing arbitration awards in court.

An acceleration clause commonly exists in contracts where periodic payments are contemplated by the agreement. For example, if you signed a lease for your housing unit, then you most likely pay rent on a month-to-month basis. If you breached your lease, you would still owe rent for each subsequent month contemplated by the lease agreement. This means that your landlord would have new injury every month that you did not pay. An acceleration clause accelerates all payments due under the contract on breach. This allows the injured party—in this case, the landlord—to sue for all damages due for unpaid rent under that contract at once, rather than having to bring a new suit each month to seek monthly unpaid rent.

A liquidated damages clause allows parties to set the amount of damages in the event of breach. Agreeing to a damage amount before any breach occurs can save money and time spent litigating. Providing that the liquidated damages clause does not look like a penalty, the clause will be valid and enforced by a court that hears a dispute arising under the contract. For example, imagine that you entered into a contract for the sale of your car. If the liquidated damages clause provided for two thousand dollars of damages in the event of breach, that will probably be a valid liquidated damages clause, providing that your car is an "average" car. However, if the liquidated damages clause provided for one million dollars of damages payable by the breaching party, then that would not be enforceable by the court because it looks like a penalty. The proposed liquidated damages far exceed the value of the car that is the subject of the agreement.

Of course, there are additional common elements to contracts. This is not an exhaustive study of possible provisions, though it is a list of commonly encountered elements. For example, time of performance is often included as a separate provision. However, time for performance is an essential element in common-law contract formation, and without it, the contract may fail due to lack of definite and certain terms in formation.

A major assumption made about a written contract is that it is integrated, which means that it contains the entire expression of the parties' agreement. That means that any statements made before the parties signed the contract are not part of the contract, unless those statements are memorialized in the contract itself. In fact, any statements or actions that are not captured within the four corners of the contract are considered parol evidence, and they will not be used to interpret the meaning of the contract.

Key Takeaways

Parties to contracts must not only take care to form the agreement so that it is legally enforceable, but they must also be aware of the properties of contracts in general, as well as specific provisions contained within contracts to which they are a party. Properties of contracts include ability to assign, delegate, and exclude parol evidence. Several types of contracts clauses are

commonly used to restrict rights and limit liability.

Exercise 8.4.1

1. Think of an example of an exculpatory clause that you have signed. For what type of activity would you be unwilling to sign an exculpatory clause? If your refusal to sign the exculpatory clause or agreement prevented you from participating in that activity, would you still refuse to sign it?
2. Do you think that too many limitations and restrictions can be placed on parties in a contract? Should there be more government regulation and standardization of contract terms between private parties? Why or why not?

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8.5: Concluding Thoughts

Contracts are an integral part of business. Without contracts, promises would not be enforceable, which would wreak havoc on our financial stability, both individually and professionally.

The law presumes that people who sign contracts have read the contract and understood its terms. Of course, contract language includes many terms of art, and simply reading a contract alone may not be enough to fully understand its implications. Contracts for important matters should be reviewed and explained by attorneys, so that parties who enter into contracts do not do so without understanding the agreement.

It's important to understand the implications of making promises. If those promises carry legal duties, then, barring a defense, the promise will need to be performed so that the obligation or duties arising under that promise can be discharged. If the promise is not performed, and if there are no defenses, then the contract has been breached. Breach is an actionable claim, with the goal of recovering the loss and placing the nonbreaching party back to the position that he or she would have been in if the contract had not been breached.

Recognizing fundamental elements of contracts and how to incorporate considerations important to you when entering into them can go far toward ensuring business success. Likewise, the failure to recognize the traps and tricks that can be incorporated into contracts can derail a good business idea.

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9: INTRODUCTION TO TORT LAW

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9.1: Chapter Introduction

Learning Objectives

LEARNING OBJECTIVES

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

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

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

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9.2: Purpose of Tort Laws

Learning Objectives

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

Definition of *Tort*

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

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

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

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

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

Kinds of Torts

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

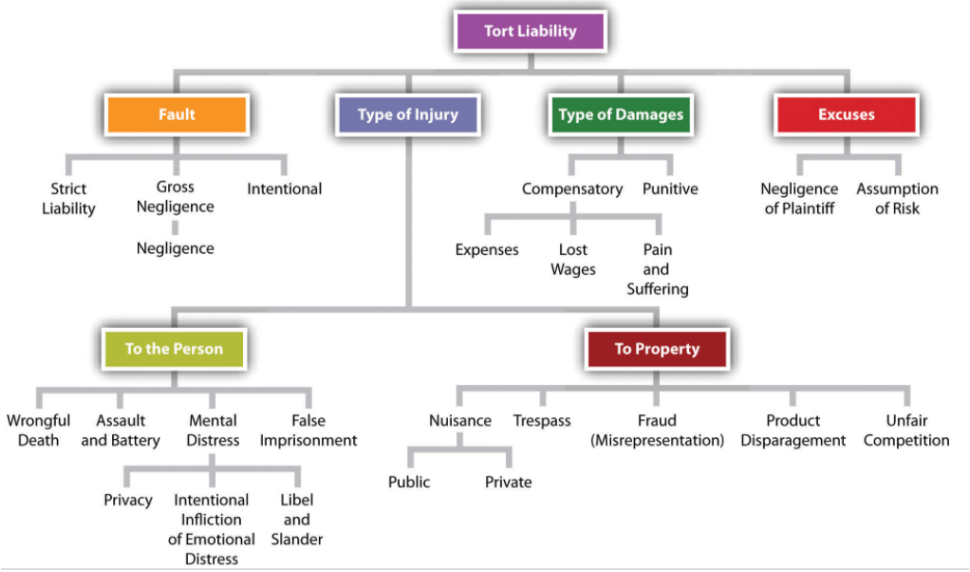
Dimensions of Tort Liability

There is a clear moral basis for recovery through the legal system where the defendant has been careless (negligent) or has intentionally caused harm. Using the concepts that we are free and autonomous beings with basic rights, we can see that when

others interfere with either our freedom or our autonomy, we will usually react negatively. As the old saying goes, “Your right to swing your arm ends at the tip of my nose.” The law takes this even one step further: under intentional tort law, if you frighten someone by swinging your arms toward the tip of her nose, you may have committed the tort of assault, even if there is no actual touching (battery).

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

Figure 7.1 *Dimensions of Tort Liability*



Dimensions of Tort: Fault

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

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

Most tort suits do not rely on *intentional* fault. They are based, rather, on negligent conduct that in the circumstances is careless or poses unreasonable risks of causing damage. Most automobile accident and medical malpractice suits are examples of negligence suits.

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

Dimensions of Tort: Nature of Injury

Tort liability varies by the type of injury caused. The most obvious type is physical harm to the person (assault, battery, infliction of

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

Dimensions of Tort: Excuses

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

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

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

Damages

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

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

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

Key Takeaway

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

Exercises

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

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9.3: Intentional Torts

Learning Objectives

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

The analysis of most intentional torts is straightforward and parallels the substantive crimes already discussed in Chapter 6 "Criminal Law". 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 "Cases") 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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9.4: Negligence

Learning Objectives

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

Elements of Negligence

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 man.” 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 man” 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 man 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 man" 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*, 551 P.2d 334 (Calif. 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

"For want of a nail, the kingdom was lost," as the old saying has it. 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 unforseeable.

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 "Cases"), 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 his 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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9.5: Strict Liability

Learning Objectives

1. Understand how strict liability torts differ from negligent torts.
2. Understand the historical origins of strict liability under common law.
3. Be able to apply strict liability concepts to liability for defective products.
4. 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 "Cases").

Strict Liability for Products

Because of the importance of products liability, this text devotes an entire chapter to it (Chapter 17 "Products Liability"). 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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9.6: Cases

Intentional Torts: False Imprisonment

Lester v. Albers Super Markets, Inc.

94 Ohio App. 313, 114 N.E.2d 529 (Ohio 1952)

Facts: The plaintiff, carrying a bag of rolls purchased at another store, entered the defendant's grocery store to buy some canned fruit. Seeing her bus outside, she stepped out of line and put the can on the counter. The store manager intercepted her and repeatedly demanded that she submit the bag to be searched. Finally she acquiesced; he looked inside and said she could go. She testified that several people witnessed the scene, which lasted about fifteen minutes, and that she was humiliated. The jury awarded her $800. She also testified that no one laid a hand on her or made a move to restrain her from leaving by any one of numerous exits.

* * *

MATTHEWS, JUDGE.

As we view the record, it raises the fundamental question of what is imprisonment. Before any need for a determination of illegality arises there must be proof of imprisonment. In 35 Corpus Juris Secundum (C.J.S.), False Imprisonment, § II, pages 512–13, it is said: "Submission to the mere verbal direction of another, unaccompanied by force or by threats of any character, cannot constitute a false imprisonment, and there is no false imprisonment where an employer interviewing an employee declines to terminate the interview if no force or threat of force is used and false imprisonment may not be predicated on a person's unfounded belief that he was restrained."

Many cases are cited in support of the text.

* * *

In Fenn v. Kroger Grocery & Baking Co., Mo. Sup., 209 S.W. 885, 887, the court said:

A case was not made out for false arrest. The plaintiff said she was intercepted as she started to leave the store; that Mr. Krause stood where she could not pass him in going out. She does not say that he made any attempt to intercept her. She says he escorted her back to the desk, that he asked her to let him see the change.

...She does not say that she went unwillingly...Evidence is wholly lacking to show that she was detained by force or threats. It was probably a disagreeable experience, a humiliating one to her, but she came out victorious and was allowed to go when she desired with the assurance of Mr. Krause that it was all right. The demurrer to the evidence on both counts was properly sustained.

The result of the cases is epitomized in 22 Am.Jur. 368, as follows:

A customer or patron who apparently has not paid for what he has received may be detained for a reasonable time to investigate the circumstances, but upon payment of the demand, he has the unqualified right to leave the premises without restraint, so far as the proprietor is concerned, and it is false imprisonment for a private individual to detain one for an unreasonable time, or under unreasonable circumstances, for the purpose of investigating a dispute over the payment of a bill alleged to be owed by the person detained for cash services.

* * *

For these reasons, the judgment is reversed and final judgment entered for the defendant-appellant.

CASE QUESTIONS

1. The court begins by saying what false imprisonment is not. What is the legal definition of false imprisonment?

2. What kinds of detention are permissible for a store to use in accosting those that may have been shoplifting?
3. Jody broke up with Jeremy and refused to talk to him. Jeremy saw Jody get into her car near the business school and parked right behind her so she could not move. He then stood next to the driver's window for fifteen minutes, begging Jody to talk to him. She kept saying, "No, let me leave!" Has Jeremy committed the tort of false imprisonment?

Negligence: Duty of Due Care

Whitlock v. University of Denver

744 P.2d 54 (Supreme Court of Colorado1987)

On June 19, 1978, at approximately 10:00 p.m., plaintiff Oscar Whitlock suffered a paralyzing injury while attempting to complete a one-and-three-quarters front flip on a trampoline. The injury rendered him a quadriplegic. The trampoline was owned by the Beta Theta Pi fraternity (the Beta house) and was situated on the front yard of the fraternity premises, located on the University campus. At the time of his injury, Whitlock was twenty years old, attended the University of Denver, and was a member of the Beta house, where he held the office of acting house manager. The property on which the Beta house was located was leased to the local chapter house association of the Beta Theta Pi fraternity by the defendant University of Denver.

Whitlock had extensive experience jumping on trampolines. He began using trampolines in junior high school and continued to do so during his brief tenure as a cadet at the United States Military Academy at West Point, where he learned to execute the one-and-three-quarters front flip. Whitlock testified that he utilized the trampoline at West Point every other day for a period of two months. He began jumping on the trampoline owned by the Beta house in September of 1977. Whitlock recounted that in the fall and spring prior to the date of his injury, he jumped on the trampoline almost daily. He testified further that prior to the date of his injury, he had successfully executed the one-and-three-quarters front flip between seventy-five and one hundred times.

During the evening of June 18 and early morning of June 19, 1978, Whitlock attended a party at the Beta house, where he drank beer, vodka and scotch until 2:00 a.m. Whitlock then retired and did not awaken until 2:00 p.m. on June 19. He testified that he jumped on the trampoline between 2:00 p.m. and 4:00 p.m., and again at 7:00 p.m. At 10:00 p.m., the time of the injury, there again was a party in progress at the Beta house, and Whitlock was using the trampoline with only the illumination from the windows of the fraternity house, the outside light above the front door of the house, and two street lights in the area. As Whitlock attempted to perform the one-and-three-quarters front flip, he landed on the back of his head, causing his neck to break.

Whitlock brought suit against the manufacturer and seller of the trampoline, the University, the Beta Theta Pi fraternity and its local chapter, and certain individuals in their capacities as representatives of the Beta Theta Pi organizations. Whitlock reached settlements with all of the named defendants except the University, so only the negligence action against the University proceeded to trial. The jury returned a verdict in favor of Whitlock, assessing his total damages at $ 7,300,000. The jury attributed twenty-eight percent of causal negligence to the conduct of Whitlock and seventy-two percent of causal negligence to the conduct of the University. The trial court accordingly reduced the amount of the award against the University to $ 5,256,000.

The University moved for judgment notwithstanding the verdict, or, in the alternative, a new trial. The trial court granted the motion for judgment notwithstanding the verdict, holding that as a matter of law, no reasonable jury could have found that the University was more negligent than Whitlock, and that the jury's monetary award was the result of sympathy, passion or prejudice.

A panel of the court of appeals reversed...by a divided vote. *Whitlock v. University of Denver,* 712 P.2d 1072 (Colo. App. 1985). The court of appeals held that the University owed Whitlock a duty of due care to remove the trampoline from the fraternity premises or to supervise its use....The case was remanded to the trial court with orders to reinstate the verdict and damages as determined by the jury. The University then petitioned for certiorari review, and we granted that petition.

II.

A negligence claim must fail if based on circumstances for which the law imposes no duty of care upon the defendant for the benefit of the plaintiff. [Citations] Therefore, if Whitlock's judgment against the University is to be upheld, it must first be determined that the University owed a duty of care to take reasonable measures to protect him against the injury that he sustained.

Whether a particular defendant owes a legal duty to a particular plaintiff is a question of law. [Citations] "The court determines, as a matter of law, the existence and scope of the duty—that is, whether the plaintiff's interest that has been infringed by the conduct

of the defendant is entitled to legal protection." [Citations] In *Smith v. City & County of Denver,* 726 P.2d 1125 (Colo. 1986), we set forth several factors to be considered in determining the existence of duty in a particular case:

Whether the law should impose a duty requires consideration of many factors including, for example, the risk involved, the foreseeability and likelihood of injury as weighed against the social utility of the actor's conduct, the magnitude of the burden of guarding against injury or harm, and the consequences of placing the burden upon the actor.

...A court's conclusion that a duty does or does not exist is "an expression of the sum total of those considerations of policy which lead the law to say that the plaintiff is [or is not] entitled to protection."

...

We believe that the fact that the University is charged with negligent failure to act rather than negligent affirmative action is a critical factor that strongly militates against imposition of a duty on the University under the facts of this case. In determining whether a defendant owes a duty to a particular plaintiff, the law has long recognized a distinction between action and a failure to act—"that is to say, between active misconduct working positive injury to others [misfeasance] and passive inaction or a failure to take steps to protect them from harm [nonfeasance]." W. Keeton, § 56, at 373. Liability for nonfeasance was slow to receive recognition in the law. "The reason for the distinction may be said to lie in the fact that by 'misfeasance' the defendant has created a new risk of harm to the plaintiff, while by 'nonfeasance' he has at least made his situation no worse, and has merely failed to benefit him by interfering in his affairs." *Id.* The *Restatement (Second) of Torts* § 314 (1965) summarizes the law on this point as follows:

The fact that an actor realizes or should realize that action on his part is necessary for another's aid or protection does not of itself impose upon him a duty to take such action.

Imposition of a duty in all such cases would simply not meet the test of fairness under contemporary standards.

In nonfeasance cases the existence of a duty has been recognized only during the last century in situations involving a limited group of special relationships between parties. Such special relationships are predicated on "some definite relation between the parties, of such a character that social policy justifies the imposition of a duty to act." W. Keeton, § 56, at 374. Special relationships that have been recognized by various courts for the purpose of imposition of a duty of care include common carrier/passenger, innkeeper/guest, possessor of land/invited entrant, employer/employee, parent/child, and hospital/patient. *See Restatement (Second) of Torts* § 314 A (1965); 3 Harper and James, § 18.6, at 722–23. The authors of the *Restatement (Second) of Torts* § 314 A, comment b (1965), state that "the law appears...to be working slowly toward a recognition of the duty to aid or protect in any relation of dependence or of mutual dependence."

...

III.

The present case involves the alleged negligent failure to act, rather than negligent action. The plaintiff does not complain of any affirmative action taken by the University, but asserts instead that the University owed to Whitlock the duty to assure that the fraternity's trampoline was used only under supervised conditions comparable to those in a gymnasium class, or in the alternative to cause the trampoline to be removed from the front lawn of the Beta house....If such a duty is to be recognized, it must be grounded on a special relationship between the University and Whitlock. According to the evidence, there are only two possible sources of a special relationship out of which such a duty could arise in this case: the status of Whitlock as a student at the University, and the lease between the University and the fraternity of which Whitlock was a member. We first consider the adequacy of the student-university relationship as a possible basis for imposing a duty on the University to control or prohibit the use of the trampoline, and then examine the provisions of the lease for that same purpose.

A.

The student-university relationship has been scrutinized in several jurisdictions, and it is generally agreed that a university is not an insurer of its students' safety. [Citations] The relationship between a university and its students has experienced important change over the years. At one time, college administrators and faculties stood in loco parentis to their students, which created a special relationship "that imposed a duty on the college to exercise control over student conduct and, reciprocally, gave the students certain rights of protection by the college." *Bradshaw,* 612 F.2d at 139. However, in modern times there has evolved a

gradual reapportionment of responsibilities from the universities to the students, and a corresponding departure from the in loco parentis relationship. *Id.* at 139–40. Today, colleges and universities are regarded as educational institutions rather than custodial ones. *Beach,* 726 P.2d at 419 (contrasting colleges and universities with elementary and high schools).

...

...By imposing a duty on the University in this case, the University would be encouraged to exercise more control over private student recreational choices, thereby effectively taking away much of the responsibility recently recognized in students for making their own decisions with respect to private entertainment and personal safety. Such an allocation of responsibility would "produce a repressive and inhospitable environment, largely inconsistent with the objectives of a modern college education." *Beach,* 726 P.2d at 419.

The evidence demonstrates that only in limited instances has the University attempted to impose regulations or restraints on the private recreational pursuits of its students, and the students have not looked to the University to assure the safety of their recreational choices. Nothing in the University's student handbook, which contains certain regulations concerning student conduct, reflects an effort by the University to control the risk-taking decisions of its students in their private recreation....Indeed, fraternity and sorority self-governance with minimal supervision appears to have been fostered by the University.

...

Aside from advising the Beta house on one occasion to put the trampoline up when not in use, there is no evidence that the University officials attempted to assert control over trampoline use by the fraternity members. We conclude from this record that the University's very limited actions concerning safety of student recreation did not give Whitlock or the other members of campus fraternities or sororities any reason to depend upon the University for evaluation of the safety of trampoline use....Therefore, we conclude that the student-university relationship is not a special relationship of the type giving rise to a duty of the University to take reasonable measures to protect the members of fraternities and sororities from risks of engaging in extra-curricular trampoline jumping.

The plaintiff asserts, however, that we should recognize a duty of the University to take affirmative action to protect fraternity members because of the foreseeability of the injury, the extent of the risks involved in trampoline use, the seriousness of potential injuries, and the University's superior knowledge concerning these matters. The argument in essence is that a duty should spring from the University's natural interest in the welfare and safety of its students, its superior knowledge of the nature and degree of risk involved in trampoline use, and its knowledge of the use of trampolines on the University campus. The evidence amply supports a conclusion that trampoline use involves risks of serious injuries and that the potential for an injury such as that experienced by Whitlock was foreseeable. It shows further that prior injuries resulting from trampoline accidents had been reported to campus security and to the student clinic, and that University administrators were aware of the number and severity of trampoline injuries nationwide.

The record, however, also establishes through Whitlock's own testimony that he was aware of the risk of an accident and injury of the very nature that he experienced....

We conclude that the relationship between the University and Whitlock was not one of dependence with respect to the activities at issue here, and provides no basis for the recognition of a duty of the University to take measures for protection of Whitlock against the injury that he suffered.

B.

We next examine the lease between the University and the fraternity to determine whether a special relationship between the University and Whitlock can be predicated on that document. The lease was executed in 1929, extends for a ninety-nine year term, and gives the fraternity the option to extend the term for another ninety-nine years. The premises are to be occupied and used by the fraternity "as a fraternity house, clubhouse, dormitory and boarding house, and generally for religious, educational, social and fraternal purposes." Such occupation is to be "*under control of the tenant.*" (emphasis added) The annual rental at all times relevant to this case appears from the record to be one dollar. The University has the obligation to maintain the grounds and make necessary repairs to the building, and the fraternity is to bear the cost of such maintenance and repair.

...

We conclude that the lease, and the University's actions pursuant to its rights under the lease, provide no basis of dependence by

the fraternity members upon which a special relationship can be found to exist between the University and the fraternity members that would give rise to a duty upon the University to take affirmative action to assure that recreational equipment such as a trampoline is not used under unsafe conditions.

IV.

Considering all of the factors presented, we are persuaded that under the facts of this case the University of Denver had no duty to Whitlock to eliminate the private use of trampolines on its campus or to supervise that use. There exists no special relationship between the parties that justifies placing a duty upon the University to protect Whitlock from the well-known dangers of using a trampoline. Here, a conclusion that a special relationship existed between Whitlock and the University sufficient to warrant the imposition of liability for nonfeasance would directly contravene the competing social policy of fostering an educational environment of student autonomy and independence.

We reverse the judgment of the court of appeals and return this case to that court with directions to remand it to the trial court for dismissal of Whitlock's complaint against the University.

CASE QUESTIONS

1. How are comparative negligence numbers calculated by the trial court? How can the jury say that the university is 72 percent negligent and that Whitlock is 28 percent negligent?
2. Why is this not an assumption of risk case?
3. Is there any evidence that Whitlock was contributorily negligent? If not, why would the court engage in comparative negligence calculations?

Negligence: Proximate Cause

Palsgraf v. Long Island R.R.

248 N.Y. 339,162 N.E. 99 (N.Y. 1928)

CARDOZO, Chief Judge

Plaintiff was standing on a platform of defendant's railroad after buying a ticket to go to Rockaway Beach. A train stopped at the station, bound for another place. Two men ran forward to catch it. One of the men reached the platform of the car without mishap, though the train was already moving. The other man, carrying a package, jumped aboard the car, but seemed unsteady as if about to fall. A guard on the car, who had held the door open, reached forward to help him in, and another guard on the platform pushed him from behind. In this act, the package was dislodged, and fell upon the rails. It was a package of small size, about fifteen inches long, and was covered by a newspaper. In fact it contained fireworks, but there was nothing in its appearance to give notice of its contents. The fireworks when they fell exploded. The shock of· the explosion threw down some scales at the other end of the platform many feet away. The scales struck the plaintiff, causing injuries for which she sues.

The conduct of the defendant's guard, if a wrong in its relation to the holder of the package, was not a wrong in its relation to the plaintiff, standing far away. Relatively to her it was not negligence at all. Nothing in the situation gave notice that the falling package had in it the potency of peril to persons thus removed. Negligence is not actionable unless it involves the invasion of a legally protected interest, the violation of a right. "Proof of negligence in the air, so to speak, will not do....If no hazard was apparent to the eye of ordinary vigilance, an act innocent and harmless, at least to outward seeming, with reference to her, did not take to itself the quality of a tort because it happened to be a wrong, though apparently not one involving the risk of bodily insecurity, with reference to someone else....The plaintiff sues in her own right for a wrong personal to her, and not as the vicarious beneficiary of a breach of duty to another.

A different conclusion will involve us, and swiftly too, in a maze of contradictions. A guard stumbles over a package which has been left upon a platform.

It seems to be a bundle of newspapers. It turns out to be a can of dynamite. To the eye of ordinary vigilance, the bundle is abandoned waste, which may be kicked or trod on with impunity. Is a passenger at the other end of the platform protected by the law against the unsuspected hazard concealed beneath the waste? If not, is the result to be any different, so far as the distant passenger is concerned, when the guard stumbles over a valise which a truckman or a porter has left upon the walk?...The orbit

of the danger as disclosed to the eye of reasonable vigilance would be the orbit of the duty. One who jostles one's neighbor in a crowd does not invade the rights of others standing at the outer fringe when the unintended contact casts a bomb upon the ground. The wrongdoer as to them is the man who carries the bomb, not the one who explodes it without suspicion of the danger. Life will have to be made over, and human nature transformed, before prevision so extravagant can be accepted as the norm of conduct, the customary standard to which behavior must conform.

The argument for the plaintiff is built upon the shifting meanings of such words as "wrong" and "wrongful" and shares their instability. For what the plaintiff must show is a "wrong" to herself; i.e., a violation of her own right, and not merely a "wrong" to someone else, nor conduct "wrongful" because unsocial, but not a "wrong" to anyone. We are told that one who drives at reckless speed through a crowded city street is guilty of a negligent act and therefore of a wrongful one, irrespective of the consequences.

Negligent the act is, and wrongful in the sense that it is unsocial, but wrongful and unsocial in relation to other travelers, only because the eye of vigilance perceives the risk of damage. If the same act were to be committed on a speedway or a race course, it would lose its wrongful quality. The risk reasonably to be perceived defines the duty to be obeyed, and risk imports relation; it is risk to another or to others within the range of apprehension. This does not mean, of course, that one who launches a destructive force is always relieved of liability, if the force, though known to be destructive, pursues an unexpected path....Some acts, such as shooting are so imminently dangerous to anyone who may come within reach of the missile however unexpectedly, as to impose a duty of prevision not far from that of an insurer. Even today, and much oftener in earlier stages of the law, one acts sometimes at one's peril....These cases aside, wrong-is defined in terms of the natural or probable, at least when unintentional....Negligence, like risk, is thus a term of relation.

Negligence in the abstract, apart from things related, is surely not a tort, if indeed it is understandable at all....One who seeks redress at law does not make out a cause of action by showing without more that there has been damage to his person. If the harm was not willful, he must show that the act as to him had possibilities of danger so many and apparent as to entitle him to be protected against the doing of it though the harm was unintended.

* * *

The judgment of the Appellate Division and that of the Trial Term should be reversed, and the complaint dismissed, with costs in all courts.

CASE QUESTIONS

1. Is there actual cause in this case? How can you tell?
2. Why should Mrs. Palsgraf (or her insurance company) be made to pay for injuries that were caused by the negligence of the Long Island Rail Road?
3. How is this accident *not* foreseeable?

Klein v. Pyrodyne Corporation

Klein v. Pyrodyne Corporation

810 P.2d 917 (Supreme Court of Washington 1991)

Pyrodyne Corporation (Pyrodyne) is a licensed fireworks display company that contracted to display fireworks at the Western Washington State Fairgrounds in Puyallup, Washington, on July 4,1987. During the fireworks display, one of the mortar launchers discharged a rocket on a horizontal trajectory parallel to the earth. The rocket exploded near a crowd of onlookers, including Danny Klein. Klein's clothing was set on fire, and he suffered facial burns and serious injury to his eyes. Klein sued Pyrodyne for strict liability to recover for his injuries. Pyrodyne asserted that the Chinese manufacturer of the fireworks was negligent in producing the rocket and therefore Pyrodyne should not be held liable. The trial court applied the doctrine of strict liability and held in favor of Klein. Pyrodyne appealed.

Section 519 of the Restatement (Second) of Torts provides that any party carrying on an "abnormally dangerous activity" is strictly liable for ensuing damages. The public display of fireworks fits this definition. The court stated: "Any time a person ignites rockets with the intention of sending them aloft to explode in the presence of large crowds of people, a high risk of serious personal injury or property damage is created. That risk arises because of the possibility that a rocket will malfunction or be misdirected." Pyrodyne argued that its liability was cut off by the Chinese manufacturer's negligence. The court rejected this argument, stating, "Even if negligence may properly be regarded as an intervening cause, it cannot function to relieve Pyrodyne from strict liability."

The Washington Supreme Court held that the public display of fireworks is an abnormally dangerous activity that warrants the imposition of strict liability.

Affirmed.

CASE QUESTIONS

1. Why would certain activities be deemed ultrahazardous or abnormally dangerous so that strict liability is imposed?
2. If the activities are known to be abnormally dangerous, did Klein assume the risk?
3. Assume that the fireworks were negligently manufactured in China. Should Klein's only remedy be against the Chinese company, as Pyrodyne argues? Why or why not?

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9.7: Summary and Exercises

Summary

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

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

What constitutes a legal injury depends very much on the circumstances. A person can assume a risk or consent to the particular action, thus relieving the person doing the injury from tort liability. To be liable, the tortfeasor must be the proximate cause of the injury, not a remote cause. On the other hand, certain people are held to answer for the torts of another—for example, an employer is usually liable for the torts of his employees, and a bartender might be liable for injuries caused by someone to whom he sold too many drinks. Two types of statutes—workers' compensation and no-fault automobile insurance—have eliminated tort liability for certain kinds of accidents and replaced it with an immediate insurance payment plan.

Among the torts of particular importance to the business community are wrongful death and personal injury caused by products or acts of employees, misrepresentation, defamation, and interference with contractual relations.

Exercises

1. What is the difference in objectives between tort law and criminal law?
2. A woman fell ill in a store. An employee put the woman in an infirmary but provided no medical care for six hours, and she died. The woman's family sued the store for wrongful death. What arguments could the store make that it was not liable? What arguments could the family make? Which seem the stronger arguments? Why?
3. The signals on a railroad crossing are defective. Although the railroad company was notified of the problem a month earlier, the railroad inspector has failed to come by and repair them. Seeing the all-clear signal, a car drives up and stalls on the tracks as a train rounds the bend. For the past two weeks the car had been stalling, and the driver kept putting off taking the car to the shop for a tune-up. As the train rounds the bend, the engineer is distracted by a conductor and does not see the car until it is too late to stop. Who is negligent? Who must bear the liability for the damage to the car and to the train?
4. Suppose in the *Katko v. Briney* case (Section 7.2 "Intentional Torts") that instead of setting such a device, the defendants had simply let the floor immediately inside the front door rot until it was so weak that anybody who came in and took two steps straight ahead would fall through the floor and to the cellar. Will the defendant be liable in this case? What if they invited a realtor to appraise the place and did not warn her of the floor? Does it matter whether the injured person is a trespasser or an invitee?
5. Plaintiff's husband died in an accident, leaving her with several children and no money except a valid insurance policy by which she was entitled to $5,000. Insurance Company refused to pay, delaying and refusing payment and meanwhile "inviting" Plaintiff to accept less than $5,000, hinting that it had a defense. Plaintiff was reduced to accepting housing and charity from relatives. She sued the insurance company for bad-faith refusal to settle the claim and for the intentional infliction of emotional distress. The lower court dismissed the case. Should the court of appeals allow the matter to proceed to trial?

SELF-TEST QUESTIONS

1. Catarina falsely accuses Jeff of stealing from their employer. The statement is defamatory only if a. a third party hears it
   b. Nick suffers severe emotional distress as a result
   c. the statement is the actual and proximate cause of his distress
   d. the statement is widely circulated in the local media and on Twitter
2. Garrett files a suit against Colossal Media Corporation for defamation. Colossal has said that Garrett is a "sleazy, corrupt public official" (and provided some evidence to back the claim). To win his case, Garrett will have to show that Colossal acted

with a. malice
b. ill will
c. malice aforethought
d. actual malice

3. Big Burger begins a rumor, using social media, that the meat in Burger World is partly composed of ground-up worms. The rumor is not true, as Big Burger well knows. Its intent is to get some customers to shift loyalty from Burger World to Big Burger. Burger World's best cause of action would be a. trespass on the case
b. nuisance
c. product disparagement
d. intentional infliction of emotional distress
4. Wilfred Phelps, age 65, is driving his Nissan Altima down Main Street when he suffers the first seizure of his life. He loses control of his vehicle and runs into three people on the sidewalk. Which statement is true? a. He is liable for an intentional tort.
b. He is liable for a negligent tort.
c. He is not liable for a negligent tort.
d. He is liable under strict liability, because driving a car is abnormally dangerous.
5. Jonathan carelessly bumps into Amanda, knocking her to the ground. He has committed the tort of negligence a. only if Amanda is injured
b. only if Amanda is not injured
c. whether or not Amanda is injured

SELF-TEST AnswerS

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

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9.8.1: Chapter Introduction

Learning Objectives

After reading this chapter, you should understand the following:

1. Why and how contract law has developed
2. What a contract is
3. What topics will be discussed in the contracts chapter of this book
4. What the sources of contract law are
5. How contracts are classified (basic taxonomy)

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9.8.2: General Perspectives on Contracts

Learning Objectives

1. Explain contract law's cultural roots: how it has evolved as capitalism has evolved.
2. Understand that contracts serve essential economic purposes.
3. Define contract.
4. Understand the basic issues in contract law.

The Role of Contracts in Modern Society

Contract is probably the most familiar legal concept in our society because it is so central to the essence of our political, economic, and social life. In common parlance, contract is used interchangeably with *agreement*, *bargain*, *undertaking*, or *deal*. Whatever the word, the concept it embodies is 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, 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: that affairs should be ordered based on mutual assent was mostly unknown. In primitive societies and in feudal Europe, relationships among people were largely fixed; traditions spelled out duties that each person owed to family, tribe, or manor. People were born into an ascribed position—a status (not unlike the caste system still existing in India)—and social mobility was limited. Sir Henry Maine, a nineteenth-century British historian, wrote that "the movement of the progressive societies has...been a movement from status to contract."Sir Henry Maine, *Ancient Law* (1869), 180–82. This movement was not accidental—it developed with the emerging industrial order. From the fifteenth to the nineteenth century, England evolved into a booming mercantile economy, with flourishing trade, growing cities, an expanding monetary system, the commercialization of agriculture, and mushrooming manufacturing. With this evolution, contract law was created of necessity.

Contract law did not develop according to a conscious plan, however. It was a response to changing conditions, and the judges who created it frequently resisted, preferring the imagined quieter 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, and help create, modern capitalism.

Modern capitalism, indeed, would not be possible without contract law. So it is that in planned economies, like those of the former Soviet Union and precapitalistic China, the contract did not determine the nature of an economic transaction. That transaction was first set forth by the state's planning authorities; only thereafter were the predetermined provisions set down in a written contract. Modern capitalism has demanded new contract regimes in Russia and China; the latter adopted its Revised Contract Law in 1999.

Contract law may be viewed economically as well as culturally. In *An Economic Analysis of Law*, Judge Richard A. Posner (a former University of Chicago law professor) suggests that contract law performs three significant economic functions. First, it helps maintain incentives for 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 troubles that have arisen in the past, thus making it easier to plan the transactions more intelligently and avoid potential pitfalls. Richard A. Posner, *Economic Analysis of Law* (New York: Aspen, 1973).

The Definition of *Contract*

As usual in the law, the legal definition of **contract** is formalistic. The Restatement (Second) of Contracts (Section 1) 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." 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."Uniform Commercial Code,

Section 1-201(11). As operational definitions, these two are circular; in effect, a contract is defined as an agreement that the law will hold the parties to.

Most simply, a contract is a legally enforceable promise. This implies that not every promise or agreement creates a binding contract; if every promise did, the simple definition set out in the preceding sentence would read, “A contract is a promise.” But—again—a contract is not simply a promise: it is a legally enforceable promise. The law takes into account the way in which contracts are made, by whom they are made, and for what purposes they are made. For example, in many states, a wager is unenforceable, even though both parties “shake” on the bet. We will explore these issues in the chapters to come.

Overview of the Contracts Chapter

Although contract law has many wrinkles and nuances, it consists of four principal inquiries, each of which will be taken up in subsequent chapters:

1. Did the parties create a valid contract? Four elements are necessary for a valid contract:
    1. Mutual assent (i.e., offer and acceptance), Chapter 9 "The Agreement"
    2. Real assent (no duress, undue influence, misrepresentation, mistake, or incapacity), Chapter 10 "Real Assent"
    3. Consideration, Chapter 11 "Consideration"
    4. Legality, Chapter 12 "Legality"
2. What does the contract mean, and is it in the proper form to carry out this meaning? Sometimes contracts need to be in writing (or evidenced by some writing), or they can’t be enforced. Sometimes it isn’t clear what the contract means, and a court has to figure that out. These problems are taken up in Chapter 13 "Form and Meaning".
3. Do persons other than the contracting parties have rights or duties under the contract? Can the right to receive a benefit from the contract be assigned, and can the duties be delegated so that a new person is responsible? Can persons not a party to the contract sue to enforce its terms? These questions are addressed in Chapter 14 "Third-Party Rights".
4. How do contractual duties terminate, and what remedies are available if a party has breached the contract? These issues are taken up in Chapter 15 "Discharge of Obligations" and Chapter 16 "Remedies".

Together, the answers to these four basic inquiries determine the rights and obligations of contracting parties.

Key Takeaway

Contract law developed when the strictures of feudalism dissipated, when a person’s position in society came to be determined by personal choice (by mutual agreement) and not by status (by how a person was born). Capitalism and contract law have developed together, because having choices in society means that people decide and agree to do things with and to each other, and those agreements bind the parties; the agreements must be enforceable.

Exercises

1. Why is contract law necessary in a society where a person’s status is not predetermined by birth?
2. Contract law serves some economic functions. What are they?

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9.8.3: Sources of Contract Law

Learning Objectives

1. Understand that contract law comes from two sources: judges (cases) and legislation.
2. Know what the Restatement of Contracts is.
3. Recognize the Convention on Contracts for the International Sale of Goods.

The most important sources of contract law are state case law and state statutes (though there are also many federal statutes governing how contracts are made by and with the federal government).

Case Law

Law made by judges is called **case law**. Because contract law was made up in the common-law courtroom by individual judges as they applied rules to resolve disputes before them, it grew over time to formidable proportions. By the early twentieth century, tens of thousands of contract disputes had been submitted to the courts for resolution, and the published opinions, if collected in one place, would have filled dozens of bookshelves. Clearly this mass of material was too unwieldy for efficient use. A similar problem also had developed in the other leading branches of the common law.

Disturbed by the profusion of cases and the resulting uncertainty of the law, a group of prominent American judges, lawyers, and law teachers founded the American Law Institute (ALI) in 1923 to attempt to clarify, simplify, and improve the law. One of the ALI's first projects, and ultimately one of its most successful, was the drafting of the **Restatement of the Law of Contracts**, completed in 1932. A revision—the Restatement (Second) of Contracts—was undertaken in 1964 and completed in 1979. Hereafter, references to "the Restatement" pertain to the Restatement (Second) of Contracts.

The Restatements—others exist in the fields of torts, agency, conflicts of laws, judgments, property, restitution, security, and trusts—are detailed analyses of the decided cases in each field. These analyses are made with an eye to discerning the various principles that have emerged from the courts, and to the maximum extent possible, the Restatements declare the law as the courts have determined it to be. The Restatements, guided by a reporter (the director of the project) and a staff of legal scholars, go through several so-called tentative drafts—sometimes as many as fifteen or twenty—and are screened by various committees within the ALI before they are eventually published as final documents.

The Restatement (Second) of Contracts won prompt respect in the courts and has been cited in innumerable cases. The Restatements are not authoritative, in the sense that they are not actual judicial precedents; but they are nevertheless weighty interpretive texts, and judges frequently look to them for guidance. They are as close to "black letter" rules of law as exist anywhere in the American common-law legal system.

Common law, case law (the terms are synonymous), governs contracts for the sale of real estate and services. "Services" refer to acts or deeds (like plumbing, drafting documents, driving a car) as opposed to the sale of property.

Statutory Law: The Uniform Commercial Code

Common-law contract principles govern contracts for real estate and services. Because of the historical development of the English legal system, contracts for the sale of goods came to be governed by a different body of legal rules. In its modern American manifestation, that body of rules is an important statute: the **Uniform Commercial Code (UCC)**, especially **Article 2**, which deals with the sale of goods.

History of the UCC

A bit of history is in order. Before the UCC was written, commercial law varied, sometimes greatly, from state to state. This first proved a nuisance and then a serious impediment to business as the American economy became nationwide during the twentieth century. Although there had been some uniform laws concerned with commercial deals—including the Uniform Sales

Act, first published in 1906—few were widely adopted and none nationally. As a result, the law governing sales of goods, negotiable instruments, warehouse receipts, securities, and other matters crucial to doing business in an industrial market economy was a crazy quilt of untidy provisions that did not mesh well from state to state.

The UCC is a model law developed by the ALI and the National Conference of Commissioners on Uniform State Laws; it has been adopted in one form or another by the legislatures in all fifty states, the District of Columbia, and the American territories. It is a "national" law not enacted by Congress—it is not federal law but uniform state law.

Initial drafting of the UCC began in 1942 and was ten years in the making, involving the efforts of hundreds of practicing lawyers, law teachers, and judges. A final draft, promulgated by the ALI, was endorsed by the American Bar Association and published in 1951. Various revisions followed in different states, threatening the uniformity of the UCC. The ALI responded by creating a permanent editorial board to oversee future revisions. In one or another of its various revisions, the UCC has been adopted in whole or in part in all American jurisdictions. The UCC is now a basic law of relevance to every business and business lawyer in the United States, even though it is not entirely uniform because different states have adopted it at various stages of its evolution—an evolution that continues still.

Organization of the UCC

The UCC consists of nine major substantive articles; each deals with separate though related subjects. The articles are as follows:

- Article 1: General Provisions
- Article 2: Sales
- Article 2A: Leases
- Article 3: Commercial Paper
- Article 4: Bank Deposits and Collections
- Article 4A: Funds Transfers
- Article 5: Letters of Credit
- Article 6: Bulk Transfers
- Article 7: Warehouse Receipts, Bills of Lading, and Other Documents of Title
- Article 8: Investment Securities
- Article 9: Secured Transactions

Article 2 deals only with the sale of goods, which the UCC defines as "all things...which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid."Uniform Commercial Code, Section 2-105. The only contracts and agreements covered by Article 2 are those relating to the present or future sale of goods.

Article 2 is divided in turn into six major parts: (1) Form, Formation, and Readjustment of Contract; (2) General Obligation and Construction of Contract; (3) Title, Creditors, and Good Faith Purchasers; (4) Performance; (5) Breach, Repudiation, and Excuse; and (6) Remedies.

Figure 8.1 Sources of Law

	Source of Law	
Type of Contract	Common Law	UCC
Real Estate	✓	
Services	✓	
Sale of Goods		✓

International Sales Law

The Convention on Contracts for the International Sale of Goods

A **Convention on Contracts for the International Sale of Goods (CISG)** was approved in 1980 at a diplomatic conference in Vienna. (A convention is a preliminary agreement that serves as the basis for a formal treaty.) The CISG has been adopted by more than forty countries, including the United States.

The CISG is significant for three reasons. First, it is a uniform law governing the sale of goods—in effect, an international Uniform Commercial Code. The major goal of the drafters was to produce a uniform law acceptable to countries with different legal, social, and economic systems. Second, although provisions in the CISG are generally consistent with the UCC, there are significant differences. For instance, under the CISG, consideration (discussed in Chapter 11 "Consideration") is not required to form a contract, and there is no Statute of Frauds (a requirement that certain contracts be evidenced by a writing). Third, the CISG represents the first attempt by the US Senate to reform the private law of business through its treaty powers, for the CISG preempts the UCC. The CISG is not mandatory: parties to an international contract for the sale of goods may choose to have their agreement governed by different law, perhaps the UCC, or perhaps, say, Japanese contract law. The CISG does not apply to contracts for the sale of (1) ships or aircraft, (2) electricity, or (3) goods bought for personal, family, or household use, nor does it apply (4) where the party furnishing the goods does so only incidentally to the labor or services part of the contract.

Key Takeaway

Judges have made contract law over several centuries by deciding cases that create, extend, or change the developing rules affecting contract formation, performance, and enforcement. The rules from the cases have been abstracted and organized in the Restatements of Contracts. To facilitate interstate commerce, contract law for many commercial transactions—especially the sale of goods—not traditionally within the purview of judges has been developed by legal scholars and presented for the states to adopt as the Uniform Commercial Code. There is an analogous Convention on Contracts for the International Sale of Goods, to which the United States is a party.

Exercises

1. How do judges make contract law?
2. What is the Restatement of the Law of Contracts, and why was it necessary?
3. Why was the Uniform Commercial Code developed, and by whom?
4. Who adopts the UCC as governing law?
5. What is the Convention on Contracts for the International Sale of Goods?

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9.8.4: Basic Taxonomy of Contracts

Learning Objectives

1. Understand that contracts are classified according to the criteria of explicitness, mutuality, enforceability, and degree of completion and that some noncontract promises are nevertheless enforceable under the doctrine of promissory estoppel.
2. Keep your eyes (and ears) alert to the use of suffixes (word endings) in legal terminology that express relationships between parties.

Some contracts are written, some oral; some are explicit, some not. Because contracts can be formed, expressed, and enforced in a variety of ways, a taxonomy of contracts has developed that is useful in grouping together like legal consequences. In general, contracts are classified along four different dimensions: explicitness, mutuality, enforceability, and degree of completion. Explicitness is the degree to which the agreement is manifest to those not party to it. Mutuality takes into account whether promises are given by two parties or only one. Enforceability is the degree to which a given contract is binding. Completion considers whether the contract is yet to be performed or whether the obligations have been fully discharged by one or both parties. We will examine each of these concepts in turn.

Explicitness

Express Contract

An **express contract** is one in which the terms are spelled out directly. The parties to an express contract, whether it is written or oral, are conscious that they are making an enforceable agreement. For example, an agreement to purchase your neighbor's car for $5,500 and to take title next Monday is an express contract.

Implied Contract (Implied in Fact)

An **implied contract** is one that is inferred from the actions of the parties. When parties have not discussed terms, an implied contract exists if it is clear from the conduct of both parties that they intended there be one. A delicatessen patron who asks for a turkey sandwich to go has made a contract and is obligated to pay when the sandwich is made. By ordering the food, the patron is implicitly agreeing to the price, whether posted or not.

The distinction between express and implied contracts has received a degree of notoriety in the so-called palimony cases, in which one member of an unmarried couple seeks a division of property after a long-standing live-together relationship has broken up. When a married couple divorces, their legal marriage contract is dissolved, and financial rights and obligations are spelled out in a huge body of domestic relations statutes and judicial decisions. No such laws exist for unmarried couples. However, about one-third of the states recognize common-law marriage, under which two people are deemed to be married if they live together with the intent to be married, regardless of their failure to have obtained a license or gone through a ceremony. Although there is no actual contract of marriage (no license), their behavior implies that the parties intended to be treated as if they were married.

Quasi-Contract

A **quasi-contract (implied in law)** is—unlike both express and implied contracts, which embody an actual agreement of the parties—an obligation said to be "imposed by law" in order to avoid unjust enrichment of one person at the expense of another. A quasi-contract is not a contract at all; it is a fiction that the courts created to prevent injustice. Suppose, for example, that the local lumberyard mistakenly delivers a load of lumber to your house, where you are repairing your deck. It was a neighbor on the next block who ordered the lumber, but you are happy to accept the load for free; since you never talked to the lumberyard, you figure you need not pay the bill. Although it is true there is no contract, the law implies a contract for the value of the material: of course you will have to pay for what you got and took. The existence of this implied contract does not depend on the intention of the parties.

Mutuality

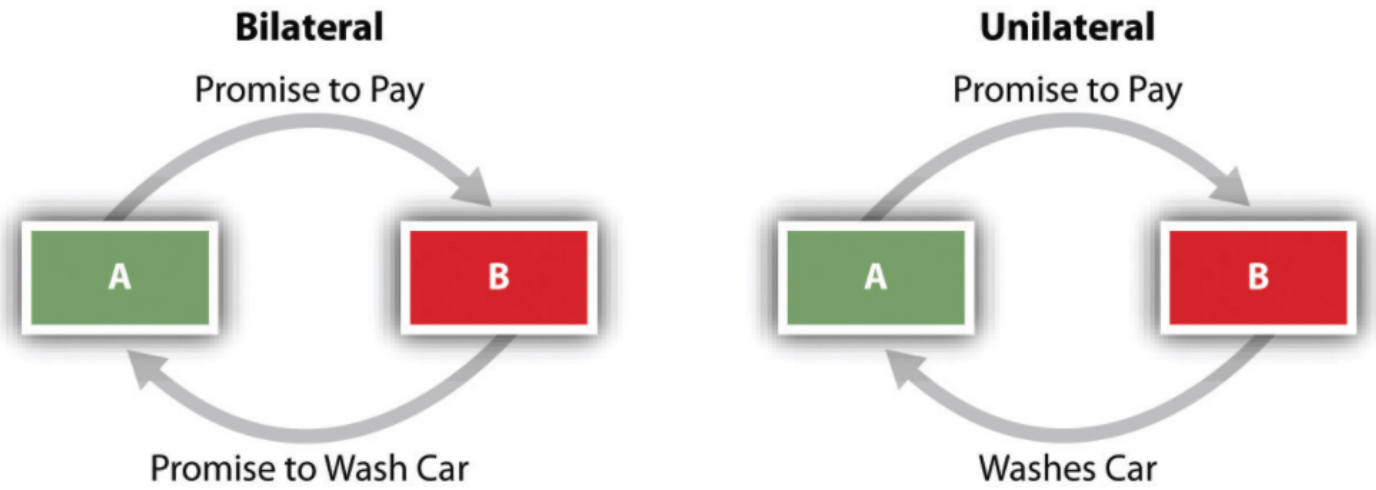
Bilateral Contract

The typical contract is one in which the parties make mutual promises. Each is both promisor and promisee; that is, each pledges to do something, and each is the recipient of such a pledge. This type of contract is called a **bilateral contract**.

Unilateral Contract

Mutual promises are not necessary to constitute a contract. **Unilateral contracts**, in which one party performs an act in exchange for the other party's promise, are equally valid. An offer of a reward—for catching a criminal or for returning a lost cat—is an example of a unilateral contract: there is an offer on one side, and the other side accepts by taking the action requested.

Figure 8.2 Bilateral and Unilateral Contracts



Enforceability

Void

Not every agreement between two people is a binding contract. An agreement that is lacking one of the legal elements of a contract is said to be a **void contract**—that is, not a contract at all. An agreement that is illegal—for example, a promise to commit a crime in return for a money payment—is void. Neither party to a void "contract" may enforce it.

Voidable

By contrast, a **voidable contract** is one that may become unenforceable by one party but can be enforced by the other. For example, a minor (any person under eighteen, in most states) may "avoid" a contract with an adult; the adult may not enforce the contract against the minor if the minor refuses to carry out the bargain. But the adult has no choice if the minor wishes the contract to be performed. (A contract may be voidable by both parties if both are minors.)

Ordinarily, the parties to a voidable contract are entitled to be restored to their original condition. Suppose you agree to buy your seventeen-year-old neighbor's car. He delivers it to you in exchange for your agreement to pay him next week. He has the legal right to terminate the deal and recover the car, in which case you will of course have no obligation to pay him. If you have already paid him, he still may legally demand a return to the status quo ante (previous state of affairs). You must return the car to him; he must return the cash to you.

A voidable contract remains a valid contract until it is voided. Thus a contract with a minor remains in force unless the minor

decides he or she does not wish to be bound by it. When the minor reaches majority, he or she may "ratify" the contract—that is, agree to be bound by it—in which case the contract will no longer be voidable and will thereafter be fully enforceable.

Unenforceable

An **unenforceable contract** is one that some rule of law bars a court from enforcing. For example, Tom owes Pete money, but Pete has waited too long to collect it and the statute of limitations has run out. The contract for repayment is unenforceable and Pete is out of luck, unless Tom makes a new promise to pay or actually pays part of the debt. (However, if Pete is holding collateral as security for the debt, he is entitled to keep it; not all rights are extinguished because a contract is unenforceable.) A debt becomes unenforceable, too, when the debtor declares bankruptcy.

A bit more on enforceability is in order. A promise or what seems to be a promise is usually enforceable only if it is otherwise embedded in the elements necessary to make that promise a contract. Those elements are mutual assent, real assent, consideration, capacity, and legality. Sometimes, though, people say things that seem like promises, and on which another person relies. In the early twentieth century, courts began, in some circumstances, to recognize that insisting on the existence of the traditional elements of contract to determine whether a promise is enforceable could work an injustice where there has been reliance. Thus developed the equitable doctrine of **promissory estoppel**, which has become an important adjunct to contract law. The Restatement (Section 90) puts it this way: "A promise which the promisor should reasonably expect to induce action or forbearance on the party of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires."

To be "estopped" means to be prohibited from denying now the validity of a promise you made before.

The doctrine has an interesting background. In 1937, High Trees House Ltd. (a British corporation) leased a block of London apartments from Central London Properties. As World War II approached, vacancy rates soared because people left the city. In 1940 the parties agreed to reduce the rent rates by half, but no term was set for how long the reduction would last. By mid-1945, as the war was ending, occupancy was again full, and Central London sued for the full rental rates from June on. The English court, under Judge Alfred Thompson Denning (1899–1999), had no difficulty finding that High Trees owed the full amount once full occupancy was again achieved, but Judge Denning went on. In an aside (called a dicta—a statement "by the way"—that is, not necessary as part of the decision), he mused about what would have happened if in 1945 Central London had sued for the full-occupancy rate back to 1940. Technically, the 1940 amendment to the 1937 contract was not binding on Central London—it lacked consideration—and Central London could have reached back to demand full-rate payment. But Judge Denning said that High Trees would certainly have relied on Central London's promise that a reduced-rate rent would be acceptable, and that would have been enough to bind it, to prevent it from acting inconsistently with the promise. He wrote, "The courts have not gone so far as to give a cause of action in damages for the breach of such a promise, but they have refused to allow the party making it to act inconsistently with it."*Central London Property Trust Ltd. v. High Trees House Ltd.* (1947) KB 130.

In the years since, though, courts *have* gone so far as to give a cause of action in damages for various noncontract promises. Contract protects agreements; promissory estoppel protects reliance, and that's a significant difference. The law of contracts continues to evolve.

Degree of Completion

An agreement consisting of a set of promises is called an **executory contract** before any promises are carried out. Most executory contracts are enforceable. If John makes an agreement to deliver wheat to Humphrey and does so, the contract is called a **partially executed contract**: one side has performed, the other has not. When John pays for the wheat, the contract is fully performed. A contract that has been carried out fully by both parties is called an **executed contract**.

Terminology: Suffixes Expressing Relationships

Although not really part of the taxonomy of contracts (i.e., the orderly classification of the subject), an aspect of contractual—indeed, legal—terminology should be highlighted here. *Suffixes* (the end syllables of words) in the English language are used to express relationships between parties in legal terminology. Here are examples:

- **Offeror.** One who makes an offer.
- **Offeree.** One to whom an offer is made.

- **Promisor.** One who makes a promise.
- **Promisee.** One to whom a promise is made.
- **Obligor.** One who makes and has an obligation.
- **Obligee.** One to whom an obligation is made.
- **Transferor.** One who makes a transfer.
- **Transferee.** One to whom a transfer is made.

Key Takeaway

Contracts are described and thus defined on the basis of four criteria: explicitness (express, implied, or quasi-contracts), mutuality (bilateral or unilateral), enforceability (void, voidable, unenforceable), and degree of completion (executory, partially executed, executed). Legal terminology in English often describes relationships between parties by the use of suffixes, to which the eye and ear must pay attention.

Exercises

1. Able *write*s to Baker: "I will mow your lawn for $20." If Baker accepts, is this an express or implied contract?
2. Able *telephone*s Baker: "I will mow your lawn for $20." Is this an express or implied contract?
3. What is the difference between a void contract and a voidable one?
4. Carr staples this poster to a utility pole: "$50 reward for the return of my dog, Argon." Describe this in contractual terms regarding explicitness, mutuality, enforceability, and degree of completion.
5. Is a voidable contract always unenforceable?
6. Contractor bids on a highway construction job, incorporating Guardrail Company's bid into its overall bid to the state. Contractor cannot accept Guardrail's offer until it gets the nod from the state. Contractor gets the nod from the state, but before it can accept Guardrail's offer, the latter revokes it. Usually a person can revoke an offer any time before it is accepted. Can Guardrail revoke its offer in this case?

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9.8.5: Cases

Explicitness: Implied Contract

Roger's Backhoe Service, Inc. v. Nichols

681 N.W.2d 647 (Iowa 2004)

Carter, J.

Defendant, Jeffrey S. Nichols, is a funeral director in Muscatine....In early 1998 Nichols decided to build a crematorium on the tract of land on which his funeral home was located. In working with the Small Business Administration, he was required to provide drawings and specifications and obtain estimates for the project. Nichols hired an architect who prepared plans and submitted them to the City of Muscatine for approval. These plans provided that the surface water from the parking lot would drain onto the adjacent street and alley and ultimately enter city storm sewers. These plans were approved by the city.

Nichols contracted with Roger's [Backhoe Service, Inc.] for the demolition of the foundation of a building that had been razed to provide room for the crematorium and removal of the concrete driveway and sidewalk adjacent to that foundation. Roger's completed that work and was paid in full.

After construction began, city officials came to the jobsite and informed Roger's that the proposed drainage of surface water onto the street and alley was unsatisfactory. The city required that an effort be made to drain the surface water into a subterranean creek, which served as part of the city's storm sewer system. City officials indicated that this subterranean sewer system was about fourteen feet below the surface of the ground....Roger's conveyed the city's mandate to Nichols when he visited the jobsite that same day.

It was Nichols' testimony at trial that, upon receiving this information, he advised...Roger's that he was refusing permission to engage in the exploratory excavation that the city required. Nevertheless, it appears without dispute that for the next three days Roger's did engage in digging down to the subterranean sewer system, which was located approximately twenty feet below the surface. When the underground creek was located, city officials examined the brick walls in which it was encased and determined that it was not feasible to penetrate those walls in order to connect the surface water drainage with the underground creek. As a result of that conclusion, the city reversed its position and once again gave permission to drain the surface water onto the adjacent street and alley.

[T]he invoices at issue in this litigation relate to charges that Roger's submitted to Nichols for the three days of excavation necessary to locate the underground sewer system and the cost for labor and materials necessary to refill the excavation with compactable materials and attain compaction by means of a tamping process....The district court found that the charges submitted on the...invoices were fair and reasonable and that they had been performed for Nichols' benefit and with his tacit approval....

The court of appeals...concluded that a necessary element in establishing an implied-in-fact contract is that the services performed be beneficial to the alleged obligor. It concluded that Roger's had failed to show that its services benefited Nichols....

In describing the elements of an action on an implied contract, the court of appeals stated in [Citation], that the party seeking recovery must show:

(1) the services were carried out under such circumstances as to give the recipient reason to understand:

(a) they were performed for him and not some other person, and

(b) they were not rendered gratuitously, but with the expectation of compensation from the recipient; and

(2) *the services were beneficial to the recipient.*

In applying the italicized language in [Citation] to the present controversy, it was the conclusion of the court of appeals that Roger's' services conferred no benefit on Nichols. We disagree. There was substantial evidence in the record to support a finding

that, unless and until an effort was made to locate the subterranean sewer system, the city refused to allow the project to proceed. Consequently, it was necessary to the successful completion of the project that the effort be made. The fact that examination of the brick wall surrounding the underground creek indicated that it was unfeasible to use that source of drainage does not alter the fact that the project was stalemated until drainage into the underground creek was fully explored and rejected. The district court properly concluded that Roger's' services conferred a benefit on Nichols....

Decision of court of appeals vacated; district court judgment affirmed.

CASE QUESTIONS

1. What facts must be established by a plaintiff to show the existence of an implied contract?
2. What argument did Nichols make as to why there was no implied contract here?
3. How would the facts have to be changed to make an express contract?

Mutuality of Contract: Unilateral Contract

SouthTrust Bank v. Williams

775 So.2d 184 (Ala. 2000)

Cook, J.

SouthTrust Bank ("SouthTrust") appeals from an order denying its motion to compel arbitration of an action against it by checking-account customers Mark Williams and Bessie Daniels. We reverse and remand.

Daniels and Williams began their relationship with SouthTrust in 1981 and 1995, respectively, by executing checking-account "signature cards." The signature card each customer signed contained a "change-in-terms" clause. Specifically, when Daniels signed her signature card, she "agree[d] to be subject to the Rules and Regulations as may now or *hereafter* be adopted by the Bank." (Emphasis added.)...[Later,] SouthTrust added paragraph 33 to the regulations:...

ARBITRATION OF DISPUTES. You and we agree that the transactions in your account involve 'commerce' under the Federal Arbitration Act ('FAA'). ANY CONTROVERSY OR CLAIM BETWEEN YOU AND US...WILL BE SETTLED BY BINDING ARBITRATION UNDER THE FAA....

This action...challenges SouthTrust's procedures for paying overdrafts, and alleges that SouthTrust engages in a "uniform practice of paying the largest check(s) before paying multiple smaller checks...[in order] to generate increased service charges for [SouthTrust] at the expense of [its customers]."

SouthTrust filed a "motion to stay [the] lawsuit and to compel arbitration." It based its motion on paragraph 33 of the regulations. [T]he trial court...entered an order denying SouthTrust's motion to compel arbitration. SouthTrust appeals....

Williams and Daniels contend that SouthTrust's amendment to the regulations, adding paragraph 33, was ineffective because, they say, they did not *expressly assent* to the amendment. In other words, they object to submitting their claims to arbitration because, they say, when they opened their accounts, neither the regulations nor any other relevant document contained an arbitration provision. They argue that "mere failure to object to the addition of a material term cannot be construed as an acceptance of it."...They contend that SouthTrust could not unilaterally insert an arbitration clause in the regulations and make it binding on depositors like them.

SouthTrust, however, referring to its change-of-terms clause insists that it "notified" Daniels and Williams of the amendment in January 1997 by enclosing in each customer's "account statement" a complete copy of the regulations, as amended. Although it is undisputed that Daniels and Williams never affirmatively assented to these amended regulations, SouthTrust contends that their assent was evidenced by their failure to close their accounts after they received notice of the amendments....Thus, the disposition of this case turns on the legal effect of Williams and Daniels's continued use of the accounts after the regulations were amended.

Williams and Daniels argue that "[i]n the context of contracts between merchants [under the UCC], a written confirmation of an acceptance may modify the contract *unless* it adds a *material* term, and arbitration clauses are material terms."...

Williams and Daniels concede—as they must—...that Article 2 governs "transactions in goods," and, consequently, that it is not

applicable to the transactions in this case. Nevertheless, they argue:

It would be astonishing if a Court were to consider the addition of an arbitration clause a material alteration to a contract between merchants, who by definition are sophisticated in the trade to which the contract applies, but *not* hold that the addition of an arbitration clause is a material alteration pursuant to a change-of-terms clause in a contract between one sophisticated party, a bank, and an entire class of less sophisticated parties, its depositors....

In response, SouthTrust states that "because of the 'at-will' nature of the relationship, banks by necessity must contractually reserve the right to amend their deposit agreements from time to time." In so stating, SouthTrust has precisely identified the fundamental difference between the transactions here and those transactions governed by [Article 2].

Contracts for the purchase and sale of goods are essentially *bilateral* and executory in nature. See [Citation] "An agreement whereby one party promises to sell and the other promises to buy a thing at a later time...is a bilateral promise of sale or contract to sell"...."[A] unilateral contract results from an exchange of a promise for an act; a bilateral contract results from an exchange of promises."...Thus, "in a unilateral contract, there is no bargaining process or exchange of promises by parties as in a bilateral contract." [Citation] "[O]nly one party makes an offer (or promise) which invites performance by another, and performance constitutes both acceptance of that offer and consideration." Because "a 'unilateral contract' is one in which no promisor receives promise as consideration for his promise," only one party is bound....The difference is not one of semantics but of substance; it determines the rights and responsibilities of the parties, including the time and the conditions under which a cause of action accrues for a breach of the contract.

This case involves at-will, commercial relationships, based upon a series of unilateral transactions. Thus, it is more analogous to cases involving insurance policies, such as [Citations]. The common thread running through those cases was the *amendment* by one of the parties to a business relationship of a document underlying that relationship—without the express assent of the other party—to require the arbitration of disputes arising after the amendment....

The parties in [the cited cases], like Williams and Daniels in this case, took no action that could be considered inconsistent with an assent to the arbitration provision. In each case, they continued the business relationship after the interposition of the arbitration provision. In doing so, they implicitly assented to the addition of the arbitration provision....

Reversed and remanded.

CASE QUESTIONS

1. Why did the plaintiffs think they should not be bound by the arbitration clause?
2. The court said this case involved a unilateral contract. What makes it that, as opposed to a bilateral contract?
3. What should the plaintiffs have done if they didn't like the arbitration requirement?

Unilateral Contract and At-Will Employment

Woolley v. Hoffmann-La Roche, Inc.

491 A.2d 1257 (N.J. 1985)

Wilntz, C. J.

Plaintiff, Richard Woolley, was hired by defendant, Hoffmann-La Roche, Inc., in October 1969, as an Engineering Section Head in defendant's Central Engineering Department at Nutley. There was no written employment contract between plaintiff and defendant. Plaintiff began work in mid-November 1969. Sometime in December, plaintiff received and read the personnel manual on which his claims are based.

[The company's personnel manual had eight pages;] five of the eight pages are devoted to "termination." In addition to setting forth the purpose and policy of the termination section, it defines "the types of termination" as "layoff," "discharge due to performance," "discharge, disciplinary," "retirement" and "resignation." As one might expect, layoff is a termination caused by lack of work, retirement a termination caused by age, resignation a termination on the initiative of the employee, and discharge due to performance and discharge, disciplinary, are both terminations for cause. There is no category set forth for discharge without cause. The termination section includes "Guidelines for discharge due to performance," consisting of a fairly detailed procedure to be used before an employee may be fired for cause. Preceding these definitions of the five categories of termination

is a section on “Policy,” the first sentence of which provides: “It is the policy of Hoffmann-La Roche to retain to the extent consistent with company requirements, the services of all employees who perform their duties efficiently and effectively.”

In 1976, plaintiff was promoted, and in January 1977 he was promoted again, this latter time to Group Leader for the Civil Engineering, the Piping Design, the Plant Layout, and the Standards and Systems Sections. In March 1978, plaintiff was directed to write a report to his supervisors about piping problems in one of defendant’s buildings in Nutley. This report was written and submitted to plaintiff’s immediate supervisor on April 5, 1978. On May 3, 1978, stating that the General Manager of defendant’s Corporate Engineering Department had lost confidence in him, plaintiff’s supervisors requested his resignation. Following this, by letter dated May 22, 1978, plaintiff was formally asked for his resignation, to be effective July 15, 1978.

Plaintiff refused to resign. Two weeks later defendant again requested plaintiff’s resignation, and told him he would be fired if he did not resign. Plaintiff again declined, and he was fired in July.

Plaintiff filed a complaint alleging breach of contract....The gist of plaintiff’s breach of contract claim is that the express and implied promises in defendant’s employment manual created a contract under which he could not be fired at will, but rather only for cause, and then only after the procedures outlined in the manual were followed. Plaintiff contends that he was not dismissed for good cause, and that his firing was a breach of contract.

Defendant’s motion for summary judgment was granted by the trial court, which held that the employment manual was not contractually binding on defendant, thus allowing defendant to terminate plaintiff’s employment at will. The Appellate Division affirmed. We granted certification.

The employer’s contention here is that the distribution of the manual was simply an expression of the company’s “philosophy” and therefore free of any possible contractual consequences. The former employee claims it could reasonably be read as an explicit statement of company policies intended to be followed by the company in the same manner as if they were expressed in an agreement signed by both employer and employees....

This Court has long recognized the capacity of the common law to develop and adapt to current needs....The interests of employees, employers, and the public lead to the conclusion that the common law of New Jersey should limit the right of an employer to fire an employee at will.

In order for an offer in the form of a promise to become enforceable, it must be accepted. Acceptance will depend on what the promisor bargained for: he may have bargained for a return promise that, if given, would result in a bilateral contract, both promises becoming enforceable. Or he may have bargained for some action or nonaction that, if given or withheld, would render his promise enforceable as a unilateral contract. In most of the cases involving an employer’s personnel policy manual, the document is prepared without any negotiations and is voluntarily distributed to the workforce by the employer. It seeks no return promise from the employees. It is reasonable to interpret it as seeking continued work from the employees, who, in most cases, are free to quit since they are almost always employees at will, not simply in the sense that the employer can fire them without cause, but in the sense that they can quit without breaching any obligation. Thus analyzed, the manual is an offer that seeks the formation of a unilateral contract—the employees’ bargained-for action needed to make the offer binding being their continued work when they have no obligation to continue.

The unilateral contract analysis is perfectly adequate for that employee who was aware of the manual and who continued to work intending that continuation to be the action in exchange for the employer’s promise; it is even more helpful in support of that conclusion if, but for the employer’s policy manual, the employee would have quit. See generally M. Petit, “Modern Unilateral Contracts,” 63 Boston Univ. Law Rev. 551 (1983) (judicial use of unilateral contract analysis in employment cases is widespread).

...All that this opinion requires of an employer is that it be fair. It would be unfair to allow an employer to distribute a policy manual that makes the workforce believe that certain promises have been made and then to allow the employer to renege on those promises. What is sought here is basic honesty: if the employer, for whatever reason, does not want the manual to be capable of being construed by the court as a binding contract, there are simple ways to attain that goal. All that need be done is the inclusion in a very prominent position of an appropriate statement that there is no promise of any kind by the employer contained in the manual; that regardless of what the manual says or provides, the employer promises nothing and remains free to change wages and all other working conditions without having to consult anyone and without anyone’s agreement; and that the employer continues to have the absolute power to fire anyone with or without good cause.

Reversed and remanded for trial.

CASE QUESTIONS

1. What did Woolley do to show his acceptance of the terms of employment offered to him?
2. In part of the case not included here, the court notes that Mr. Woolley died “before oral arguments on this case.” How can there be any damages if the plaintiff has died? Who now has any case to pursue?
3. The court here is changing the law of employment in New Jersey. It is making case law, and the rule here articulated governs similar future cases in New Jersey. Why did the court make this change? Why is it relevant that the court says it would be easy for an employer to avoid this problem?

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9.8: INTRODUCTION TO CONTRACT LAW

9.8.1: Chapter Introduction

9.8.2: General Perspectives on Contracts

9.8.3: Sources of Contract Law

9.8.4: Basic Taxonomy of Contracts

9.8.5: Cases

9.8.6: Summary and Exercises

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9.8.6: Summary and Exercises

Summary

Contract law developed as the status-centered organization of feudal society faded and people began to make choices about how they might order their lives. In the capitalistic system, people make choices about how to interact with others, and—necessarily—those choices expressed as promises must be binding and enforceable.

The two fundamental sources of contract law are (1) the common law as developed in the state courts and as summarized in the Restatement (Second) of Contracts and (2) the Uniform Commercial Code for the sale of goods. In general, the UCC is more liberal than the common law in upholding the existence of a contract.

Types of contracts can be distinguished by four criteria: (1) express and implied, including quasi-contracts implied by law; (2) bilateral and unilateral; (3) enforceable and unenforceable; and (4) completed (executed) and uncompleted (executory). To understand contract law, it is necessary to master these distinctions and their nuances.

Exercises

1. a. Mr. and Mrs. Smith, an elderly couple, had no relatives. When Mrs. Smith became ill, the Smiths asked a friend, Henrietta, to help with various housekeeping chores, including cleaning and cooking. Although the Smiths never promised to pay her, Henrietta performed the chores for eighteen months. Henrietta now claims that she is entitled to the reasonable value of the services performed. Is she correct? Explain.
   b. Assume instead that the Smiths asked Mrs. Smith's sister, Caroline, who lived nearby, to help with the housekeeping. After eighteen months, Caroline claims she is entitled to the reasonable value of the services performed. Is she correct? Explain.
2. A letter from Bridge Builders Inc. to the Allied Steel Company stated, "We offer to purchase 10,000 tons of No. 4 steel pipe at today's quoted price for delivery two months from today. Your acceptance must be received in five days." Does Bridge Builders intend to create a bilateral or a unilateral contract? Why?
3. Roscoe's barber persuaded him to try a new hair cream called Sansfree, which the barber applied to Roscoe's hair and scalp. The next morning Roscoe had a very unpleasant rash along his hairline. Upon investigation he discovered that the rash was due to an improper chemical compound in Sansfree. If Roscoe filed a breach of contract action against the barber, would the case be governed by the Uniform Commercial Code or common law? Explain.
4. Rachel entered into a contract to purchase a 2004 Dodge from Hanna, who lived in the neighboring apartment. When a dispute arose over the terms of the contract, Hanna argued that, because neither she nor Rachel was a merchant, the dispute should be decided under general principles of common law. Rachel, on the other hand, argued that Hanna was legally considered to be a merchant because she sold the car for profit and that, consequently, the sale was governed by the Uniform Commercial Code. Who is correct? Explain.
5. Lee and Michelle decided to cohabit. When they set up house, Michelle gave up her career, and Lee promised to share his earnings with her on a fifty-fifty basis. Several years later they ended their relationship, and when Lee failed to turn over half of his earnings, Michelle filed suit on the basis of Lee's promise. What kind of contract would Michelle allege that Lee had breached? Explain.
6. Harry and Wilma were divorced in 2008, and Harry was ordered in the divorce decree to pay his ex-wife $10,000. In 2009 and 2010 Harry was hospitalized, incurring $3,000 in bills. He and Wilma discussed the matter, and Wilma agreed to pay the bill with her own money, even though Harry still owed her $5,000 from the divorce decree. When Harry died in late 2010, Wilma made a claim against his estate for $8,000 (the $3,000 in medical bills and the $5,000 from the decree), but the estate was only willing to pay the $5,000 from the decree, claiming she had paid the hospital bill voluntarily and had no contract for repayment. Is the estate correct? Explain.
7. Louie, an adult, entered into a contract to sell a case of scotch whiskey to Leroy, a minor. Is the contract void or voidable? Explain.
8. James Mann owned a manufacturing plant that assembled cell phones. A CPA audit determined that several phones were missing. Theft by one or more of the workers was suspected. Accordingly, under Mann's instructions, the following sign was placed in the employees' cafeteria:

   Reward. We are missing phones. I want all employees to watch for thievery. A reward of $500 will be paid for information given by any employee that leads to the apprehension of employee thieves.

—James Mann

Waldo, a plant employee, read the notice and immediately called Mann, stating, “I accept your offer. I promise to watch other employees and provide you with the requested information.” Has a contract been formed? Explain.

9. Almost every day Sally took a break at lunch and went to the International News Stand—a magazine store—to browse the newspapers and magazines and chat with the owner, Conrad. Often she bought a magazine. One day she went there, browsed a bit, and took a magazine off the rack. Conrad was busy with three customers. Sally waved the magazine at Conrad and left the store with it. What kind of a contract, if any, was created?
10. Joan called Devon Sand & Gravel and ordered two “boxes” (dump-truck loads) of gravel to be spread on her rural driveway by the “shoot and run” method: the tailgate is partially opened, the dump-truck bed is lifted, and the truck moves down the driveway spreading gravel as it goes. The driver mistakenly graveled the driveway of Joan’s neighbor, Watson, instead of Joan’s. Is Devon entitled to payment by Watson? Explain.

SELF-TEST QUESTIONS

1. An implied contract a. must be in writing
   b. is one in which the terms are spelled out
   c. is one inferred from the actions of the parties
   d. is imposed by law to avoid an unjust result
   e. may be avoided by one party
2. The Convention on Contracts for the International Sale of Goods is a. an annual meeting of international commercial purchasing agents.
   b. contract law used in overseas US federal territories
   c. a customary format or template for drafting contracts
   d. a kind of treaty setting out international contract law, to which the United States is a party
   e. the organization that develops uniform international law
3. An unenforceable contract is a. void, not a contract at all
   b. one that a court will not enforce for either side because of a rule of law
   c. unenforceable by one party but enforceable by the other
   d. one that has been performed by one party but not the other
   e. too indefinite to be valid
4. Betty Baker found a bicycle apparently abandoned near her house. She took it home and spent $150 repairing and painting it, after which Carl appeared and proved his ownership of it. Under what theory is Betty able to get reimbursed for her expenditures? a. express contract
   b. implied contract
   c. apparent or quasi-contract
   d. executory contract
   e. none: she will not get reimbursed
5. Alice discusses with her neighbor Bob her plan to hire Woodsman to cut three trees on her side of their property line, mentioning that she can get a good deal because Woodsman is now between jobs. Bob says, “Oh, don’t do that. My brother is going to cut some trees on my side, and he can do yours too for free.” Alice agrees. But Bob’s brother is preoccupied and never does the job. Three weeks later Alice discovers Woodsman’s rates have risen prohibitively. Under what theory does Alice have a cause of action against Bob? a. express contract
   b. promissory estoppel
   c. quasi-contract
   d. implied contract
   e. none: she has no cause of action against Bob

SELF-TEST AnswerS

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

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10: PRODUCTS LIABILITY

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10.1: Chapter Introduction

Learning Objectives

After reading this chapter, you should understand the following:

1. How products-liability law allocates the costs of a consumer society
2. How warranty theory works in products liability, and what its limitations are
3. How negligence theory works, and what its problems are
4. How strict liability theory works, and what its limitations are
5. What efforts are made to reform products-liability law, and why

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10.2: Introduction, Why Products-Liability Law Is Important

Learning Objectives

1. Understand why products-liability law underwent a revolution in the twentieth century.
2. Recognize that courts play a vital role in policing the free enterprise system by adjudicating how the true costs of modern consumer culture are allocated.
3. Know the names of the modern causes of action for products-liability cases.

In previous chapters, we discussed remedies generally. In this chapter, we focus specifically on remedies available when a defective product causes personal injury or other damages. Products liability describes a type of claim, not a separate theory of liability. Products liability has strong emotional overtones—ranging from the prolitigation position of consumer advocates to the conservative perspective of the manufacturers.

History of Products-Liability Law

The theory of caveat emptor—let the buyer beware—that pretty much governed consumer law from the early eighteenth century until the early twentieth century made some sense. A horse-drawn buggy is a fairly simple device: its workings are apparent; a person of average experience in the 1870s would know whether it was constructed well and made of the proper woods. Most foodstuffs 150 years ago were grown at home and "put up" in the home kitchen or bought in bulk from a local grocer, subject to inspection and sampling; people made home remedies for coughs and colds and made many of their own clothes. Houses and furnishings were built of wood, stone, glass, and plaster—familiar substances. Entertainment was a book or a piano. The state of technology was such that the things consumed were, for the most part, comprehensible and—very important—mostly locally made, which meant that the consumer who suffered damages from a defective product could confront the product's maker directly. Local reputation is a powerful influence on behavior.

The free enterprise system confers great benefits, and no one can deny that: materialistically, compare the image sketched in the previous paragraph with circumstances today. But those benefits come with a cost, and the fundamental political issue always is who has to pay. Consider the following famous passage from Upton Sinclair's great novel *The Jungle*. It appeared in 1906. He wrote it to inspire labor reform; to his dismay, the public outrage focused instead on consumer protection reform. Here is his description of the sausage-making process in a big Chicago meatpacking plant:

There was never the least attention paid to what was cut up for sausage; there would come all the way back from Europe old sausage that had been rejected, and that was moldy and white—it would be dosed with borax and glycerin, and dumped into the hoppers, and made over again for home consumption. There would be meat that had tumbled out on the floor, in the dirt and sawdust, where the workers had tramped and spit uncounted billions of consumption germs. There would be meat stored in great piles in rooms; and the water from leaky roofs would drip over it, and thousands of rats would race about on it. It was too dark in these storage places to see well, but a man could run his hand over these piles of meat and sweep off handfuls of the dried dung of rats. These rats were nuisances, and the packers would put poisoned bread out for them; they would die, and then rats, bread, and meat would go into the hoppers together. This is no fairy story and no joke; the meat would be shoveled into carts, and the man who did the shoveling would not trouble to lift out a rat even when he saw one—there were things that went into the sausage in comparison with which a poisoned rat was a tidbit. There was no place for the men to wash their hands before they ate their dinner, and so they made a practice of washing them in the water that was to be ladled into the sausage. There were the butt-ends of smoked meat, and the scraps of corned beef, and all the odds and ends of the waste of the plants, that would be dumped into old barrels in the cellar and left there.

Under the system of rigid economy which the packers enforced, there were some jobs that it only paid to do once in a long time, and among these was the cleaning out of the waste barrels. Every spring they did it; and in the barrels would be dirt and rust and old nails and stale water—and cartload after cartload of it would be taken up and dumped into the hoppers with fresh meat, and sent out to the public's breakfast. Some of it they would make into "smoked" sausage—but as the smoking took time, and was therefore expensive, they would call upon their chemistry department, and preserve it with borax and color it with gelatin to make it brown. All of their sausage came out of the same bowl, but when they came to wrap it they would stamp some of it "special," and for this they would charge two cents more a pound.Upton Sinclair, *The Jungle* (New York: Signet Classic, 1963), 136.

It became clear from Sinclair's exposé that associated with the marvels of then-modern meatpacking and distribution methods was food poisoning: a true cost became apparent. When the true cost of some money-making enterprise (e.g., cigarettes) becomes inescapably apparent, there are two possibilities. First, the legislature can in some way mandate that the manufacturer itself pay the cost; with the meatpacking plants, that would be the imposition of sanitary food-processing standards. Typically, Congress creates an administrative agency and gives the agency some marching orders, and then the agency crafts regulations dictating as many industry-wide reform measures as are politically possible. Second, the people who incur damages from the product (1) suffer and die or (2) access the machinery of the legal system and sue the manufacturer. If plaintiffs win enough lawsuits, the manufacturer's insurance company raises rates, forcing reform (as with high-powered muscle cars in the 1970s); the business goes bankrupt; or the legislature is pressured to act, either for the consumer or for the manufacturer.

If the industry has enough clout to blunt—by various means—a robust proconsumer legislative response so that government regulation is too lax to prevent harm, recourse is had through the legal system. Thus for all the talk about the need for tort reform (discussed later in this chapter), the courts play a vital role in policing the free enterprise system by adjudicating how the true costs of modern consumer culture are allocated.

Obviously the situation has improved enormously in a century, but one does not have to look very far to find terrible problems today. Consider the following, which occurred in 2009–10:

- In the United States, Toyota recalled 412,000 passenger cars, mostly the Avalon model, for steering problems that reportedly led to three accidents.
- Portable baby recliners that are supposed to help fussy babies sleep better were recalled after the death of an infant: the Consumer Product Safety Commission announced the recall of 30,000 Nap Nanny recliners made by Baby Matters of Berwyn, Pennsylvania.
- More than 70,000 children and teens go to the emergency room each year for injuries and complications from medical devices. Contact lenses are the leading culprit, the first detailed national estimate suggests.
- Smith and Noble recalled 1.3 million Roman shades and roller shades after a child was nearly strangled: the Consumer Product Safety Commission says a five-year-old boy in Tacoma, Washington, was entangled in the cord of a roller shade in May 2009.FindLaw, AP reports.
- The Consumer Product Safety Commission reported that 4,521 people were killed in the United States in consumer-product-related incidences in 2009, and millions of people visited hospital emergency rooms from consumer-product-related injuries.US Consumer Product Safety Commission, *2009 Report to the President and the Congress*, accessed March 1, 2011, www.cpsc.gov/cpscpub/pubs/reports/2009rpt.pdf.
- Reports about the possibility that cell-phone use causes brain cancer continue to be hotly debated. Critics suggest that the studies minimizing the risk were paid for by cell-phone manufacturers.Matt Hamblen, "New Study Warns of Cell Phone Dangers," *Computerworld US*, August 9, 2009, accessed March 1, 2011, news.techworld.com/personal-t...-phone-dangers.

Products liability can also be a life-or-death matter from the manufacturer's perspective. In 2009, Bloomberg BusinessWeek reported that the costs of product safety for manufacturing firms can be enormous: "Peanut Corp., based in Lynchberg, Va., has been driven into bankruptcy since health officials linked tainted peanuts to more than 600 illnesses and nine deaths. Mattel said the first of several toy recalls it announced in 2007 cut its quarterly operating income by $30 million. Earlier this decade, Ford Motor spent roughly $3 billion replacing 10.6 million potentially defective Firestone tires."Michael Orey, "Taking on Toy Safety," *BusinessWeek*, March 6, 2009, accessed March 1, 2011, http://www.businessweek.com/managing...036_271002.htm. Businesses complain, with good reason, about the expenses associated with products-liability problems.

Current State of the Law

Although the debate has been heated and at times simplistic, the problem of products liability is complex and most of us regard it with a high degree of ambivalence. We are all consumers, after all, who profit greatly from living in an industrial society. In this chapter, we examine the legal theories that underlie products-liability cases that developed rapidly in the twentieth century to address the problems of product-caused damages and injuries in an industrial society.

In the typical products-liability case, three legal theories are asserted—a contract theory and two tort theories. The contract theory is **warranty**, governed by the UCC, and the two tort theories are **negligence** and **strict products liability**, governed by the common law. See Figure 17.1 "Major Products Liability Theories".

Figure 17.1 Major Products Liability Theories



Key Takeaway

As products became increasingly sophisticated and potentially dangerous in the twentieth century, and as the separation between production and consumption widened, products liability became a very important issue for both consumers and manufacturers. Millions of people every year are adversely affected by defective products, and manufacturers and sellers pay huge amounts for products-liability insurance and damages. The law has responded with causes of action that provide a means for recovery for products-liability damages.

Exercises

1. How does the separation of production from consumption affect products-liability issues?
2. What other changes in production and consumption have caused the need for the development of products-liability law?
3. How can it be said that courts adjudicate the allocation of the costs of a consumer-oriented economy?

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10.3: Warranties

Learning Objectives

1. Recognize a UCC express warranty and how it is created.
2. Understand what is meant under the UCC by implied warranties, and know the main types of implied warranties: merchantability, fitness for a particular purpose, and title.
3. Know that there are other warranties: against infringement and as may arise from usage of the trade.
4. See that there are difficulties with warranty theory as a cause of action for products liability; a federal law has addressed some of these.

The UCC governs express warranties and various implied warranties, and for many years it was the only statutory control on the use and meanings of warranties. In 1975, after years of debate, Congress passed and President Gerald Ford signed into law the Magnuson-Moss Act, which imposes certain requirements on manufacturers and others who warrant their goods. We will examine both the UCC and the Magnuson-Moss Act.

Types of Warranties

Express Warranties

An **express warranty** is created whenever the seller affirms that the product will perform in a certain manner. Formal words such as “warrant” or “guarantee” are not necessary. A seller may create an express warranty as part of the basis for the bargain of sale by means of (1) an affirmation of a fact or promise relating to the goods, (2) a description of the goods, or (3) a sample or model. Any of these will create an express warranty that the goods will conform to the fact, promise, description, sample, or model. Thus a seller who states that “the use of rustproof linings in the cans would prevent discoloration and adulteration of the Perform solution” has given an express warranty, whether he realized it or not.*Rhodes Pharmacal Co. v. Continental Can Co.*, 219 N.E.2d 726 (Ill. 1976). Claims of breach of express warranty are, at base, claims of misrepresentation.

But the courts will not hold a manufacturer to every statement that could conceivably be interpreted to be an express warranty. Manufacturers and sellers constantly “puff” their products, and the law is content to let them inhabit that gray area without having to make good on every claim. UCC 2-313(2) says that “an affirmation merely of the value of the goods or a statement purporting to be merely the seller’s opinion or commendation of the goods does not create a warranty.” Facts do.

It is not always easy, however, to determine the line between an express warranty and a piece of puffery. A salesperson who says that a strawberry huller is “great” has probably puffed, not warranted, when it turns out that strawberries run through the huller look like victims of a massacre. But consider the classic cases of the defective used car and the faulty bull. In the former, the salesperson said the car was in “A-1 shape” and “mechanically perfect.” In the latter, the seller said not only that the bull calf would “put the buyer on the map” but that “his father was the greatest living dairy bull.” The car, carrying the buyer’s seven-month-old child, broke down while the buyer was en route to visit her husband in the army during World War II. The court said that the salesperson had made an express warranty.*Wat Henry Pontiac Co. v. Bradley*, 210 P.2d 348 (Okla. 1949). The bull calf turned out to be sterile, putting the farmer on the judicial rather than the dairy map. The court said the seller’s spiel was trade talk, not a warranty that the bull would impregnate cows.*Frederickson v. Hackney*, 198 N.W. 806 (Minn. 1924).

Is there any qualitative difference between these decisions, other than the quarter century that separates them and the different courts that rendered them? Perhaps the most that can be said is that the more specific and measurable the statement’s standards, the more likely it is that a court will hold the seller to a warranty, and that a written statement is easier to construe as a warranty than an oral one. It is also possible that courts look, if only subliminally, at how reasonable the buyer was in relying on the statement, although this ought not to be a strict test. A buyer may be unreasonable in expecting a car to get 100 miles to the gallon, but if that is what the seller promised, that ought to be an enforceable warranty.

The CISG (Article 35) provides, “The seller must deliver goods which are of the quantity, quality and description required by the contract and which are contained or packaged in the manner required by the contract. [And the] goods must possess the qualities of goods which the seller has held out to the buyer as a sample or model.”

Implied Warranties

Express warranties are those over which the parties dickered—or could have. Express warranties go to the essence of the bargain. An **implied warranty**, by contrast, is one that circumstances alone, not specific language, compel reading into the sale. In short, an implied warranty is one created by law, acting from an impulse of common sense.

Implied Warranty of Merchantability

Section 2-314 of the UCC lays down the fundamental rule that goods carry an **implied warranty of merchantability** if sold by a merchant-seller. What is merchantability? Section 2-314(2) of the UCC says that merchantable goods are those that conform at least to the following six characteristics:

1. Pass without objection in the trade under the contract description
2. In the case of fungible goods, are of fair average quality within the description
3. Are fit for the ordinary purposes for which such goods are used
4. Run, within the variations permitted by the agreement, of even kind, quality, and quantity within each unit and among all units involved
5. Are adequately contained, packaged, and labeled as the agreement may require
6. Conform to the promise or affirmations of fact made on the container or label if any

For the purposes of Section 2-314(2)(c) of the UCC, selling and serving food or drink for consumption on or off the premises is a sale subject to the implied warranty of merchantability—the food must be "fit for the ordinary purposes" to which it is put. The problem is common: you bite into a cherry pit in the cherry-vanilla ice cream, or you choke on the clam shells in the chowder. Is such food fit for the ordinary purposes to which it is put? There are two schools of thought. One asks whether the food was natural as prepared. This view adopts the seller's perspective. The other asks what the consumer's reasonable expectation was.

The first test is sometimes said to be the "natural-foreign" test. If the substance in the soup is natural to the substance—as bones are to fish—then the food is fit for consumption. The second test, relying on reasonable expectations, tends to be the more commonly used test.

The Convention provides (Article 35) that "unless otherwise agreed, the goods sold are fit for the purposes for which goods of the same description would ordinarily be used."

Fitness for a Particular Purpose

Section 2-315 of the UCC creates another implied warranty. Whenever a seller, at the time she contracts to make a sale, knows or has reason to know that the buyer is relying on the seller's skill or judgment to select a product that is suitable for the particular purpose the buyer has in mind for the goods to be sold, there is an implied warranty that the goods are fit for that purpose. For example, you go to a hardware store and tell the salesclerk that you need a paint that will dry overnight because you are painting your front door and a rainstorm is predicted for the next day. The clerk gives you a slow-drying oil-based paint that takes two days to dry. The store has breached an **implied warranty of fitness for particular purpose**.

Note the distinction between "particular" and "ordinary" purposes. Paint is made to color and when dry to protect a surface. That is its ordinary purpose, and had you said only that you wished to buy paint, no implied warranty of fitness would have been breached. It is only because you had a particular purpose in mind that the implied warranty arose. Suppose you had found a can of paint in a general store and told the same tale, but the proprietor had said, "I don't know enough about that paint to tell you anything beyond what's on the label; help yourself." Not every seller has the requisite degree of skill and knowledge about every product he sells to give rise to an implied warranty. Ultimately, each case turns on its particular circumstances: **"The Convention provides (Article 35): [The goods must be] fit for any particular purpose expressly or impliedly made known to the seller at the time of the conclusion of the contract, except where the circumstances show that the buyer did not rely, or that it was unreasonable for him to rely, on the seller's skill and judgment."**

Other Warranties

Article 2 contains other warranty provisions, though these are not related specifically to products liability. Thus, under UCC, Section 2-312, unless explicitly excluded, the seller warrants he is conveying *good title* that is rightfully his and that the goods are transferred free of any security interest or other lien or encumbrance. In some cases (e.g., a police auction of bicycles

picked up around campus and never claimed), the buyer should know that the seller does not claim title in himself, nor that title will necessarily be good against a third party, and so subsection (2) excludes warranties in these circumstances. But the circumstances must be so obvious that no reasonable person would suppose otherwise.

In *Menzel v. List*, an art gallery sold a painting by Marc Chagall that it purchased in Paris.*Menzel v. List*, 246 N.E.2d 742 (N.Y. 1969). The painting had been stolen by the Germans when the original owner was forced to flee Belgium in the 1930s. Now in the United States, the original owner discovered that a new owner had the painting and successfully sued for its return. The customer then sued the gallery, claiming that it had breached the implied warranty of title when it sold the painting. The court agreed and awarded damages equal to the appreciated value of the painting. A good-faith purchaser who must surrender stolen goods to their true owner has a claim for breach of the implied warranty of title against the person from whom he bought the goods.

A second implied warranty, related to title, is that the merchant-seller warrants the goods are *free of any rightful claim by a third person* that the seller has infringed his rights (e.g., that a gallery has not infringed a copyright by selling a reproduction). This provision only applies to a seller who regularly deals in goods of the kind in question. If you find an old print in your grandmother's attic, you do not warrant when you sell it to a neighbor that it is free of any valid infringement claims.

A third implied warranty in this context involves the course of dealing or usage of trade. Section 2-314(3) of the UCC says that unless modified or excluded implied warranties may arise from a course of dealing or usage of trade. If a certain way of doing business is understood, it is not necessary for the seller to state explicitly that he will abide by the custom; it will be implied. A typical example is the obligation of a dog dealer to provide pedigree papers to prove the dog's lineage conforms to the contract.

Problems with Warranty Theory

In General

It may seem that a person asserting a claim for breach of warranty will have a good chance of success under an express warranty or implied warranty theory of merchantability or fitness for a particular purpose. In practice, though, claimants are in many cases denied recovery. Here are four general problems:

- The claimant must prove that there was a sale.
- The sale was of goods rather than real estate or services.
- The action must be brought within the four-year statute of limitations under Article 2-725, when the tender of delivery is made, not when the plaintiff discovers the defect.
- Under UCC, Section 2-607(3)(a) and Section 2A-516(3)(a), which covers leases, the claimant who fails to give notice of breach within a reasonable time of having accepted the goods will see the suit dismissed, and few consumers know enough to do so, except when making a complaint about a purchase of spoiled milk or about paint that wouldn't dry.

In addition to these general problems, the claimant faces additional difficulties stemming directly from warranty theory, which we take up later in this chapter.

Exclusion or Modification of Warranties

The UCC permits sellers to exclude or disclaim warranties in whole or in part. That's reasonable, given that the discussion here is about contract, and parties are free to make such contracts as they see fit. But a number of difficulties can arise.

Exclusion of Express Warranties

The simplest way for the seller to exclude express warranties is not to give them. To be sure, Section 2-316(1) of the UCC forbids courts from giving operation to words in fine print that negate or limit express warranties if doing so would unreasonably conflict with express warranties stated in the main body of the contract—as, for example, would a blanket statement that "this contract excludes all warranties express or implied." The purpose of the UCC provision is to prevent customers from being surprised by unbargained-for language.

Exclusion of Implied Warranties in General

Implied warranties can be excluded easily enough also, by describing the product with language such as "as is" or "with all faults."

Nor is exclusion simply a function of what the seller says. The buyer who has either examined or refused to examine the goods before entering into the contract may not assert an implied warranty concerning defects an inspection would have revealed.

The Convention provides a similar rule regarding a buyer's rights when he has failed to inspect the goods (Article 35): "The seller is not liable...for any lack of conformity of the goods if at the time of the conclusion of the contract the buyer knew or could not have been unaware of such lack of conformity."

Implied Warranty of Merchantability

Section 2-316(2) of the UCC permits the seller to disclaim or modify the implied warranty of merchantability, as long as the statement actually mentions "merchantability" and, if it is written, is "conspicuous." Note that the disclaimer need not be in writing, and—again—all implied warranties can be excluded as noted.

Implied Warranty of Fitness

Section 2-316(2) of the UCC permits the seller also to disclaim or modify an implied warranty of fitness. This disclaimer or modification must be in writing, however, and must be conspicuous. It need not mention fitness explicitly; general language will do. The following sentence, for example, is sufficient to exclude all implied warranties of fitness: "There are no warranties that extend beyond the description on the face of this contract."

Here is a standard disclaimer clause found in a Dow Chemical Company agreement: "Seller warrants that the goods supplied here shall conform to the description stated on the front side hereof, that it will convey good title, and that such goods shall be delivered free from any lawful security interest, lien, or encumbrance. SELLER MAKES NO WARRANTY OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR USE. NOR IS THERE ANY OTHER EXPRESS OR IMPLIED WARRANTY."

Conflict between Express and Implied Warranties

Express and implied warranties and their exclusion or limitation can often conflict. Section 2-317 of the UCC provides certain rules for deciding which should prevail. In general, all warranties are to be construed as consistent with each other and as cumulative. When that assumption is unreasonable, the parties' intention governs the interpretation, according to the following rules: (a) exact or technical specifications displace an inconsistent sample or model or general language of description; (b) a sample from an existing bulk displaces inconsistent general language of description; (c) express warranties displace inconsistent implied warranties other than an implied warranty of fitness for a particular purpose. Any inconsistency among warranties must always be resolved in favor of the implied warranty of fitness for a particular purpose. This doesn't mean that warranty cannot be limited or excluded altogether. The parties may do so. But in cases of doubt whether it or some other language applies, the implied warranty of fitness will have a superior claim.

The Magnuson-Moss Act and Phantom Warranties

After years of debate over extending federal law to regulate warranties, Congress enacted the Magnuson-Moss Federal Trade Commission Warranty Improvement Act (more commonly referred to as the Magnuson-Moss Act) and President Ford signed it in 1975. The act was designed to clear up confusing and misleading warranties, where—as Senator Magnuson put it in introducing the bill—"purchasers of consumer products discover that their warranty may cover a 25-cent part but not the $100 labor charge or that there is full coverage on a piano so long as it is shipped at the purchaser's expense to the factory....There is a growing need to generate consumer understanding by clearly and conspicuously disclosing the terms and conditions of the warranty and by telling the consumer what to do if his guaranteed product becomes defective or malfunctions." The Magnuson-Moss Act only applies to consumer products (for household and domestic uses); commercial purchasers are presumed to be knowledgeable enough not to need these protections, to be able to hire lawyers, and to be able to include the cost of product failures into the prices they charge.

The act has several provisions to meet these consumer concerns; it regulates the content of warranties and the means of disclosing those contents. The act gives the Federal Trade Commission (FTC) the authority to promulgate detailed regulations to interpret and enforce it. Under FTC regulations, any written warranty for a product costing a consumer more than ten dollars must disclose in a single document and in readily understandable language the following nine items of information:

1. The identity of the persons covered by the warranty, whether it is limited to the original purchaser or fewer than all who might

come to own it during the warranty period.
2. A clear description of the products, parts, characteristics, components, or properties covered, and where necessary for clarity, a description of what is excluded.
3. A statement of what the warrantor will do if the product fails to conform to the warranty, including items or services the warranty will pay for and, if necessary for clarity, what it will not pay for.
4. A statement of when the warranty period starts and when it expires.
5. A step-by-step explanation of what the consumer must do to realize on the warranty, including the names and addresses of those to whom the product must be brought.
6. Instructions on how the consumer can be availed of any informal dispute resolution mechanism established by the warranty.
7. Any limitations on the duration of implied warranties—since some states do not permit such limitations, the warranty must contain a statement that any limitations may not apply to the particular consumer.
8. Any limitations or exclusions on relief, such as consequential damages—as above, the warranty must explain that some states do not allow such limitations.
9. The following statement: “This warranty gives you specific legal rights, and you may also have other rights which vary from state to state.”

In addition to these requirements, the act requires that the warranty be labeled either a full or limited warranty. A **full warranty** means (1) the defective product or part will be fixed or replaced for free, including removal and reinstallation; (2) it will be fixed within a reasonable time; (3) the consumer need not do anything unreasonable (like shipping the piano to the factory) to get warranty service; (4) the warranty is good for anyone who owns the product during the period of the warranty; (5) the consumer gets money back or a new product if the item cannot be fixed within a reasonable number of attempts. But the full warranty may not cover the whole product: it may cover only the hard drive in the computer, for example; it must state what parts are included and excluded. A **limited warranty** is less inclusive. It may cover only parts, not labor; it may require the consumer to bring the product to the store for service; it may impose a handling charge; it may cover only the first purchaser. Both full and limited warranties may exclude consequential damages.

Disclosure of the warranty provisions prior to sale is required by FTC regulations; this can be done in a number of ways. The text of the warranty can be attached to the product or placed in close conjunction to it. It can be maintained in a binder kept in each department or otherwise easily accessible to the consumer. Either the binders must be in plain sight or signs must be posted to call the prospective buyer’s attention to them. A notice containing the text of the warranty can be posted, or the warranty itself can be printed on the product’s package or container.

Phantom warranties are addressed by the Magnuson-Moss Act. As we have seen, the UCC permits the seller to disclaim implied warranties. This authority often led sellers to give what were called phantom warranties—that is, the express warranty contained disclaimers of implied warranties, thus leaving the consumer with fewer rights than if no express warranty had been given at all. In the words of the legislative report of the act, “The bold print giveth, and the fine print taketh away.” The act abolished these phantom warranties by providing that if the seller gives a written warranty, whether express or implied, he cannot disclaim or modify implied warranties. However, a seller who gives a limited warranty can limit implied warranties to the duration of the limited warranty, if the duration is reasonable.

A seller’s ability to disclaim implied warranties is also limited by state law in two ways. First, by amendment to the UCC or by separate legislation, some states prohibit disclaimers whenever consumer products are sold.A number of states have special laws that limit the use of the UCC implied warranty disclaimer rules in consumer sales. Some of these appear in amendments to the UCC and others are in separate statutes. The broadest approach is that of the nine states that prohibit the disclaimer of implied warranties in consumer sales (Massachusetts, Connecticut, Maine, Vermont, Maryland, the District of Columbia, West Virginia, Kansas, Mississippi, and, with respect to personal injuries only, Alabama). There is a difference in these states whether the rules apply to manufacturers as well as retailers. Second, the UCC at 2-302 provides that unconscionable contracts or clauses will not be enforced. UCC 2-719(3) provides that limitation of damages for personal injury in the sale of “consumer goods is prima facie unconscionable, but limitation of damages where the loss is commercial is not.” (Unconscionability was discussed in Chapter 12 "Legality".)

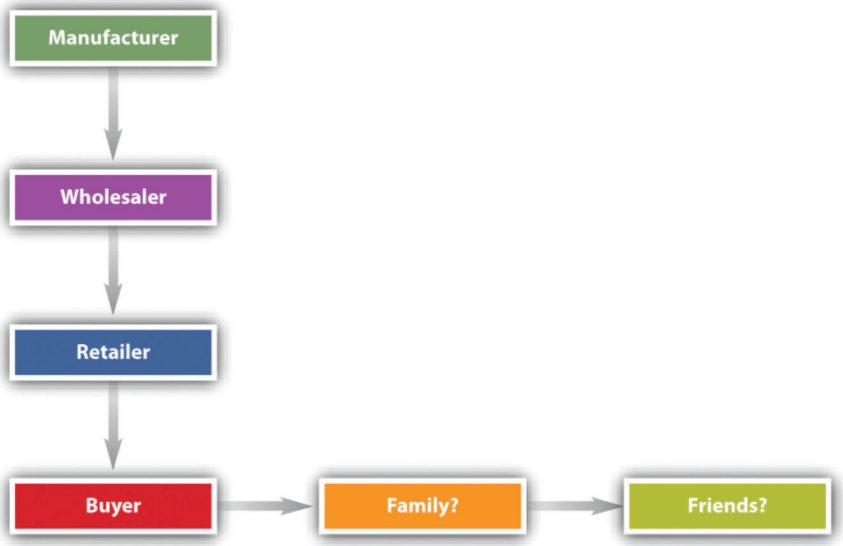
A first problem with warranty theory, then, is that it’s possible to disclaim or limit the warranty. The worst abuses of manipulative and tricky warranties are eliminated by the Magnuson-Moss Act, but there are several other reasons that warranty theory is not the panacea for claimants who have suffered damages or injuries as a result of defective products.

Privity

A second problem with warranty law (after exclusion and modification of warranties) is that of **privity**. Privity is the legal term

for the direct connection between the seller and buyer, the two contracting parties. For decades, the doctrine of privity has held that one person can sue another only if they are in privity. That worked well in the days when most commerce was local and the connection between seller and buyer was immediate. But in a modern industrial (or postindustrial) economy, the product is transported through a much larger distribution system, as depicted in Figure 17.2 "Chain of Distribution". Two questions arise: (1) Is the manufacturer or wholesaler (as opposed to the retailer) liable to the buyer under warranty theory? and (2) May the buyer's family or friends assert warranty rights?

Figure 17.2 Chain of Distribution



Horizontal Privity

Suppose Carl Consumer buys a new lamp for his family's living room. The lamp is defective: Carl gets a serious electrical shock when he turns it on. Certainly Carl would be covered by the implied warranty of merchantability: he's in direct privity with the seller. But what if Carl's spouse Carlene is injured? She didn't buy the lamp; is she covered? Or suppose Carl's friend David, visiting for an afternoon, gets zapped. Is David covered? This gets to **horizontal privity**, noncontracting parties who suffer damages from defective goods, such as nonbuyer users, consumers, and bystanders. Horizontal privity determines to whose benefit the warranty "flows"—who can sue for its breach. In one of its rare instances of nonuniformity, the UCC does not dictate the result. It gives the states three choices, labeled in Section 2-318 as Alternatives A, B, and C.

Alternative A says that a seller's warranty extends "to any natural person who is in the family or household of his buyer or who is a guest in his home" provided (1) it is reasonable to expect the person suffering damages to use, consume, or be affected by the goods and (2) the warranty extends only to damages for personal injury.

Alternative B "extends to any natural person who may reasonably be expected to use, consume, or be affected by the goods, and who is injured in person by breach of the warranty." It is less restrictive than the first alternative: it extends protection to people beyond those in the buyer's home. For example, what if Carl took the lamp to a neighbor's house to illuminate a poker table: under Alternative B, anybody at the neighbor's house who suffered injury would be covered by the warranty. But this alternative does not extend protection to organizations; "natural person" means a human being.

Alternative C is the same as B except that it applies not only to any "natural person" but "to any person who is injured by breach of the warranty." This is the most far-reaching alternative because it provides redress for damage to *property* as well as for *personal* injury, and it extends protection to corporations and other institutional buyers.

One may incidentally note that having three different alternatives for when third-party nonpurchasers can sue a seller or manufacturer for breach of warranty gives rise to unintended consequences. First, different outcomes are produced among jurisdictions, including variations in the common law. Second, the great purpose of the Uniform Commercial Code in promoting national uniformity is undermined. Third, battles over choice of law—where to file the lawsuit—are generated.

UCC, Section 2A-216, provides basically the same alternatives as applicable to the leasing of goods.

Vertical Privity

The traditional rule was that remote selling parties were not liable: lack of privity was a defense by the manufacturer or wholesaler to a suit by a buyer with whom these entities did not themselves contract. The buyer could recover damages from the retailer but not from the original manufacturer, who after all made the product and who might be much more financially able to honor the warranty. The UCC takes no position here, but over the last fifty years the judicial trend has been to abolish this **vertical privity** requirement. (See Figure 17.2 "Chain of Distribution"; the entities in the distribution chain are those in vertical privity to the buyer.) It began in 1958, when the Michigan Supreme Court overturned the old theory in an opinion written by Justice John D. Voelker (who also wrote the novel *Anatomy of a Murder*, under the pen name Robert Traver).*Spence v. Three Rivers Builders & Masonry Supply, Inc.*, 90 N.W.2d 873 (Mich. 1958).

Contributory Negligence, Comparative Negligence, and Assumption of Risk

After disclaimers and privity issues are resolved, other possible impediments facing the plaintiff in a products-liability warranty case are issues of assumption of the risk, contributory negligence, and comparative negligence (discussed in Chapter 7 "Introduction to Tort Law" on torts).

Courts uniformly hold that assumption of risk is a defense for sellers against a claim of breach of warranty, while there is a split of authority over whether comparative and contributory negligence are defenses. However, the courts' use of this terminology is often conflicting and confusing. The ultimate question is really one of causation: was the seller's breach of the warranty the cause of the plaintiff's damages?

The UCC is not markedly helpful in clearing away the confusion caused by years of discussion of assumption of risk and contributory negligence. Section 2-715(2)(b) of the UCC says that among the forms of consequential damage for which recovery can be sought is "injury to person or property *proximately* resulting from any breach of warranty" (emphasis added). But "proximately" is a troublesome word. Indeed, ultimately it is a circular word: it means nothing more than that the defendant must have been a direct enough cause of the damages that the courts will impose liability. Comment 5 to this section says, "Where the injury involved follows the use of goods without discovery of the defect causing the damage, the question of 'proximate' turns on whether it was reasonable for the buyer to use the goods without such inspection as would have revealed the defects. If it was not reasonable for him to do so, or if he did in fact discover the defect prior to his use, the injury would not proximately result from the breach of warranty."

Obviously if a sky diver buys a parachute and then discovers a few holes in it, his family would not likely prevail in court when they sued to recover for his death because the parachute failed to function after he jumped at 5,000 feet. But the general notion that it must have been reasonable for a buyer to use goods without inspection can make a warranty case difficult to prove.

Key Takeaway

A first basis of recovery in products-liability theory is breach of warranty. There are two types of warranties: express and implied. Under the implied category are three major subtypes: the implied warranty of merchantability (only given by merchants), the implied warranty of fitness for a particular purpose, and the implied warranty of title. There are a number of problems with the use of warranty theory: there must have been a sale of the goods; the plaintiff must bring the action within the statute of limitations; and the plaintiff must notify the seller within a reasonable time. The seller may—within the constraints of the Magnuson-Moss Act—limit or exclude express warranties or limit or exclude implied warranties. Privity, or lack of it, between buyer and seller has been significantly eroded as a limitation in warranty theory, but lack of privity may still affect the plaintiff's recovery; the plaintiff's assumption of the risk in using defective goods may preclude recovery.

Exercises

1. What are the two main types of warranties and the important subtypes?
2. Who can make each type of warranty?
3. What general problems does a plaintiff have in bringing a products-liability warranty case?

4. What problems are presented concerning exclusion or manipulative express warranties, and how does the Magnuson-Moss Act address them?
5. How are implied warranties excluded?
6. What is the problem of lack of privity, and how does modern law deal with it?

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10.4: Negligence

Learning Objectives

1. Recognize how the tort theory of negligence may be of use in products-liability suits.
2. Understand why negligence is often not a satisfactory cause of action in such suits: proof of it may be difficult, and there are powerful defenses to claims of negligence.

Negligence is the second theory raised in the typical products-liability case. It is a tort theory (as compared to breach of warranty, which is of course a contract theory), and it does have this advantage over warranty theory: privity is never relevant. A pedestrian is struck in an intersection by a car whose brakes were defectively manufactured. Under no circumstances would breach of warranty be a useful cause of action for the pedestrian—there is no privity at all. Negligence is considered in detail in the Chapter 7 "Introduction to Tort Law" on torts; it basically means lack of due care.

Typical Negligence Claims: Design Defects and Inadequate Warnings

Negligence theory in products liability is most useful in two types of cases: defective design and defective warnings.

Design Defects

Manufacturers can be, and often are, held liable for injuries caused by products that were defectively designed. The question is whether the designer used reasonable care in designing a product reasonably safe for its foreseeable use. The concern over reasonableness and standards of care are elements of negligence theory.

Defective-design cases can pose severe problems for manufacturing and safety engineers. More safety means more cost. Designs altered to improve safety may impair functionality and make the product less desirable to consumers. At what point safety comes into reasonable balance with performance, cost, and desirability (see Figure 17.3 "The Reasonable Design Balance") is impossible to forecast accurately, though some factors can be taken into account. For example, if other manufacturers are marketing comparable products whose design are intrinsically safer, the less-safe products are likely to lose a test of reasonableness in court.

Figure 17.3 The Reasonable Design Balance



Warning Defects

We noted that a product may be defective if the manufacturer failed to warn the user of potential dangers. Whether a warning should have been affixed is often a question of what is reasonably foreseeable, and the failure to affix a warning will be treated as negligence. The manufacturer of a weed killer with poisonous ingredients is certainly acting negligently when it fails to warn the consumer that the contents are potentially lethal.

The law governing the necessity to warn and the adequacy of warnings is complex. What is reasonable turns on the degree to which a product is likely to be misused and, as the disturbing *Laaperi* case (Section 17.6.3 "Failure to Warn") illustrates, whether the hazard is obvious.

Problems with Negligence Theory

Negligence is an ancient cause of action and, as was discussed in the torts chapter, it carries with it a number of well-developed defenses. Two categories may be mentioned: common-law defenses and preemption.

Common-Law Defenses against Negligence

Among the problems confronting a plaintiff with a claim of negligence in products-liability suits (again, these concepts are discussed in the torts chapter) are the following:

- Proving negligence at all: just because a product is defective does not necessarily prove the manufacturer breached a duty of care.
- Proximate cause: even if there was some negligence, the plaintiff must prove her damages flowed proximately from that negligence.
- Contributory and comparative negligence: the plaintiff's own actions contributed to the damages.
- Subsequent alteration of the product: generally the manufacturer will not be liable if the product has been changed.
- Misuse or abuse of the product: using a lawn mower to trim a hedge or taking too much of a drug are examples.
- Assumption of the risk: knowingly using the product in a risky way.

Preemption

Preemption (or "pre-emption") is illustrated by this problem: suppose there is a federal standard concerning the product, and the defendant manufacturer meets it, but the standard is not really very protective. (It is not uncommon, of course, for federal standard makers of all types to be significantly influenced by lobbyists for the industries being regulated by the standards.) Is it enough for the manufacturer to point to its satisfaction of the standard so that such satisfaction preempts (takes over) any common-law negligence claim? "We built the machine to federal standards: we can't be liable. Our compliance with the federal safety standard is an affirmative defense."

Preemption is typically raised as a defense in suits about (1) cigarettes, (2) FDA-approved medical devices, (3) motor-boat propellers, (4) pesticides, and (5) motor vehicles. This is a complex area of law. Questions inevitably arise as to whether there was federal preemption, express or implied. Sometimes courts find preemption and the consumer loses; sometimes the courts don't find preemption and the case goes forward. According to one lawyer who works in this field, there has been "increasing pressure on both the regulatory and congressional fronts to preempt state laws." That is, the usual defendants (manufacturers) push Congress and the regulatory agencies to state explicitly in the law that the federal standards preempt and defeat state law.C. Richard Newsome and Andrew F. Knopf, "Federal Preemption: Products Lawyers Beware," *Florida Justice Association Journal*, July 27, 2007, accessed March 1, 2011, http://www.newsomelaw.com/resources/...lawyers-beware.

Key Takeaway

Negligence is a second possible cause of action for products-liability claimants. A main advantage is that no issues of privity are relevant, but there are often problems of proof; there are a number of robust common-law defenses, and federal preemption is a recurring concern for plaintiffs' lawyers.

Exercises

1. What two types of products-liability cases are most often brought under negligence?
2. How could it be said that merely because a person suffers injury as the result of a defective product, proof of negligence is not necessarily made?
3. What is "preemption" and how is it used as a sword to defeat products-liability plaintiffs?

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10.5: Strict Liability in Tort

Learning Objectives

1. Know what “strict products liability” means and how it differs from the other two products-liability theories.
2. Understand the basic requirements to prove strict products liability.
3. See what obstacles to recovery remain with this doctrine.

The warranties grounded in the Uniform Commercial Code (UCC) are often ineffective in assuring recovery for a plaintiff’s injuries. The notice requirements and the ability of a seller to disclaim the warranties remain bothersome problems, as does the privity requirement in those states that continue to adhere to it.

Negligence as a products-liability theory obviates any privity problems, but negligence comes with a number of familiar defenses and with the problems of preemption.

To overcome the obstacles, judges have gone beyond the commercial statutes and the ancient concepts of negligence. They have fashioned a tort theory of products liability based on the principle of **strict products liability**. One court expressed the rationale for the development of the concept as follows: “The rule of strict liability for defective products is an example of necessary paternalism judicially shifting risk of loss by application of tort doctrine because [the UCC] scheme fails to adequately cover the situation. Judicial paternalism is to loss shifting what garlic is to a stew—sometimes necessary to give full flavor to statutory law, always distinctly noticeable in its result, overwhelmingly counterproductive if excessive, and never an end in itself.”*Kaiser Steel Corp. v. Westinghouse Electric Corp.*, 127 Cal. Rptr. 838 (Cal. 1976). Paternalism or not, strict liability has become a very important legal theory in products-liability cases.

Strict Liability Defined

The formulation of strict liability that most courts use is Section 402A of the Restatement of Torts (Second), set out here in full:

(1) One who sells any product in a defective condition unreasonably dangerous to the user or consumer or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or to his property, if

(a) the seller is engaged in the business of selling such a product, and

(b) it is expected to and does reach the user or consumer without substantial change in the condition in which it is sold.

(2) This rule applies even though

(a) the seller has exercised all possible care in the preparation and sale of his product, and

(b) the user or consumer has not bought the product from or entered into any contractual relation with the seller.

Section 402A of the Restatement avoids the warranty booby traps. It states a rule of law not governed by the UCC, so limitations and exclusions in warranties will not apply to a suit based on the Restatement theory. And the consumer is under no obligation to give notice to the seller within a reasonable time of any injuries. Privity is not a requirement; the language of the Restatement says it applies to “the user or consumer,” but courts have readily found that bystanders in various situations are entitled to bring actions under Restatement, Section 402A. The formulation of strict liability, though, is limited to physical harm. Many courts have held that a person who suffers economic loss must resort to warranty law.

Strict liability avoids some negligence traps, too. No proof of negligence is required. See Figure 17.4 "Major Difference between Warranty and Strict Liability".

Figure 17.4 Major Difference between Warranty and Strict Liability

	Warranty	Strict Liability
1. Notice of Defect from Buyer to Seller Required?	Yes	No
2. Disclaimer Possible?	Yes	No
3. Privity Required?	Sometimes	No

Section 402A Elements

Product in a Defective Condition

Sales of goods but not sales of services are covered under the Restatement, Section 402A. Furthermore, the plaintiff will not prevail if the product was safe for normal handling and consumption when sold. A glass soda bottle that is properly capped is not in a defective condition merely because it can be broken if the consumer should happen to drop it, making the jagged glass dangerous. Chocolate candy bars are not defective merely because you can become ill by eating too many of them at once. On the other hand, a seller would be liable for a product defectively packaged, so that it could explode or deteriorate and change its chemical composition. A product can also be in a defective condition if there is danger that could come from an anticipated wrongful use, such as a drug that is safe only when taken in limited doses. Under those circumstances, failure to place an adequate dosage warning on the container makes the product defective.

The plaintiff bears the burden of proving that the product is in a defective condition, and this burden can be difficult to meet. Many products are the result of complex feats of engineering. Expert witnesses are necessary to prove that the products were defectively manufactured, and these are not always easy to come by. This difficulty of proof is one reason why many cases raise the failure to warn as the dispositive issue, since in the right case that issue is far easier to prove. The *Anderson* case (detailed in the exercises at the end of this chapter) demonstrates that the plaintiff cannot prevail under strict liability merely because he was injured. It is not the fact of injury that is dispositive but the defective condition of the product.

Unreasonably Dangerous

The product must be not merely dangerous but unreasonably dangerous. Most products have characteristics that make them dangerous in certain circumstances. As the Restatement commentators note, “Good whiskey is not unreasonably dangerous merely because it will make some people drunk, and is especially dangerous to alcoholics; but bad whiskey, containing a dangerous amount of fuel oil, is unreasonably dangerous....Good butter is not unreasonably dangerous merely because, if such be the case, it deposits cholesterol in the arteries and leads to heart attacks; but bad butter, contaminated with poisonous fish oil, is unreasonably dangerous.”Restatement (Second) of Contracts, Section 402A(i). Under Section 402A, “the article sold must be dangerous to an extent beyond that which would be contemplated by the ordinary consumer who purchases it, with the ordinary knowledge common to the community as to its characteristics. ”

Even high risks of danger are not necessarily unreasonable. Some products are unavoidably unsafe; rabies vaccines, for example, can cause dreadful side effects. But the disease itself, almost always fatal, is worse. A product is unavoidably unsafe when it cannot be made safe for its intended purpose given the present state of human knowledge. Because important benefits may flow from the product’s use, its producer or seller ought not to be held liable for its danger.

However, the failure to warn a potential user of possible hazards can make a product defective under Restatement, Section 402A, whether unreasonably dangerous or even unavoidably unsafe. The dairy farmer need not warn those with common allergies to eggs, because it will be presumed that the person with an allergic reaction to common foodstuffs will be aware of them. But when the product contains an ingredient that could cause toxic effects in a substantial number of people and its danger is not widely known (or if known, is not an ingredient that would commonly be supposed to be in the product), the lack of a warning could make the product unreasonably dangerous within the meaning of Restatement, Section 402A. Many of the suits brought by

asbestos workers charged exactly this point; “The utility of an insulation product containing asbestos may outweigh the known or foreseeable risk to the insulation workers and thus justify its marketing. The product could still be unreasonably dangerous, however, if unaccompanied by adequate warnings. An insulation worker, no less than any other product user, has a right to decide whether to expose himself to the risk.”*Borel v. Fibreboard Paper Products Corp.*, 493 F.Zd 1076 (5th Cir. 1973). This rule of law came to haunt the Manville Corporation: it was so burdened with lawsuits, brought and likely to be brought for its sale of asbestos—a known carcinogen—that it declared Chapter 11 bankruptcy in 1982 and shucked its liability.*In re Johns-Manville Corp.*, 36 R.R. 727 (So. Dist. N.Y. 1984).

Engaged in the Business of Selling

Restatement, Section 402A(1)(a), limits liability to sellers “engaged in the business of selling such a product.” The rule is intended to apply to people and entities engaged in business, not to casual one-time sellers. The business need not be solely in the defective product; a movie theater that sells popcorn with a razor blade inside is no less liable than a grocery store that does so. But strict liability under this rule does not attach to a private individual who sells his own automobile. In this sense, Restatement, Section 402A, is analogous to the UCC’s limitation of the warranty of merchantability to the merchant.

The requirement that the defendant be in the business of selling gets to the rationale for the whole concept of strict products liability: businesses should shoulder the cost of injuries because they are in the best position to spread the risk and distribute the expense among the public. This same policy has been the rationale for holding bailors and lessors liable for defective equipment just as if they had been sellers.*Martin v. Ryder Rental, Inc.*, 353 A.2d 581 (Del. 1976).

Reaches the User without Change in Condition

Restatement, Section 402A(1)(b), limits strict liability to those defective products that are expected to and do reach the user or consumer without substantial change in the condition in which the products are sold. A product that is safe when delivered cannot subject the seller to liability if it is subsequently mishandled or changed. The seller, however, must anticipate in appropriate cases that the product will be stored; faulty packaging or sterilization may be the grounds for liability if the product deteriorates before being used.

Liability Despite Exercise of All Due Care

Strict liability applies under the Restatement rule even though “the seller has exercised all possible care in the preparation and sale of his product.” This is the crux of “strict liability” and distinguishes it from the conventional theory of negligence. It does not matter how reasonably the seller acted or how exemplary is a manufacturer’s quality control system—what matters is whether the product was defective and the user injured as a result. Suppose an automated bottle factory manufactures 1,000 bottles per hour under exacting standards, with a rigorous and costly quality-control program designed to weed out any bottles showing even an infinitesimal amount of stress. The plant is “state of the art,” and its computerized quality-control operation is the best in the world. It regularly detects the one out of every 10,000 bottles that analysis has shown will be defective. Despite this intense effort, it proves impossible to weed out every defective bottle; one out of one million, say, will still escape detection. Assume that a bottle, filled with soda, finds its way into a consumer’s home, explodes when handled, sends glass shards into his eye, and blinds him. Under negligence, the bottler has no liability; under strict liability, the bottler will be liable to the consumer.

Liability without Contractual Relation

Under Restatement, Section 402A(2)(b), strict liability applies even though the user has not purchased the product from the seller nor has the user entered into any contractual relation with the seller. In short, privity is abolished and the injured user may use the theory of strict liability against manufacturers and wholesalers as well as retailers. Here, however, the courts have varied in their approaches; the trend has been to allow bystanders recovery. The Restatement explicitly leaves open the question of the bystander’s right to recover under strict liability.

Problems with Strict Liability

Strict liability is liability without proof of negligence and without privity. It would seem that strict liability is the “holy grail” of products-liability lawyers: the complete answer. Well, no, it’s not the holy grail. It is certainly true that 402A abolishes the contractual problems of warranty. Restatement, Section 402A, Comment *m*, says,

The rule stated in this Section is not governed by the provisions of the Uniform Commercial Code, as to warranties; and it is not affected by limitations on the scope and content of warranties, or by limitation to “buyer” and “seller” in those statutes. Nor is the consumer required to give notice to the seller of his injury within a reasonable time after it occurs, as provided by the Uniform Act. The consumer’s cause of action does not depend upon the validity of his contract with the person from whom he acquires the product, and it is not affected by any disclaimer or other agreement, whether it be between the seller and his immediate buyer, or attached to and accompanying the product into the consumer’s hands. In short, “warranty” must be given a new and different meaning if it is used in connection with this Section. It is much simpler to regard the liability here stated as merely one of strict liability in tort.

Inherent in the Restatement’s language is the obvious point that if the product has been altered, losses caused by injury are not the manufacturer’s liability. Beyond that there are still some limitations to strict liability.

Disclaimers

Comment *m* specifically says the cause of action under Restatement, Section 402A, is not affected by disclaimer. But in *nonconsumer* cases, courts have allowed clear and specific disclaimers. In 1969, the Ninth Circuit observed: “In *Kaiser Steel Corp.* the [California Supreme Court] court upheld the dismissal of a strict liability action when the parties, dealing from positions of relatively equal economic strength, contracted in a commercial setting to limit the defendant’s liability. The court went on to hold that in this situation the strict liability cause of action does not apply at all. In reaching this conclusion, the court in *Kaiser* reasoned that strict liability ‘is designed to encompass situations in which the principles of sales warranties serve their purpose “fitfully at best.”’ [Citation]” It concluded that in such commercial settings the UCC principles work well and “to apply the tort doctrines of products liability will displace the statutory law rather than bring out its full flavor.”*Idaho Power Co. v. Westinghouse Electric Corp.*, 596 F.2d 924, 9CA (1979).

Plaintiff’s Conduct

Conduct by the plaintiff herself may defeat recovery in two circumstances.

Assumption of Risk

Courts have allowed the defense of assumption of the risk in strict products-liability cases. A plaintiff assumes the risk of injury, thus establishing defense to claim of strict products liability, when he is aware the product is defective, knows the defect makes the product unreasonably dangerous, has reasonable opportunity to elect whether to expose himself to the danger, and nevertheless proceeds to make use of the product. The rule makes sense.

Misuse or Abuse of the Product

Where the plaintiff does not know a use of the product is dangerous but nevertheless uses for an incorrect purpose, a defense arises, but only if such misuse was not foreseeable. If it was, the manufacturer should warn against that misuse. In *Eastman v. Stanley Works*, a carpenter used a framing hammer to drive masonry nails; the claw of the hammer broke off, striking him in the eye.*Eastman v. Stanley Works*, 907 N.E.2d 768 (Ohio App. 2009). He sued. The court held that while a defense does exist “where the product is used in a capacity which is unforeseeable by the manufacturer and completely incompatible with the product’s design…misuse of a product suggests a use which was unanticipated or unexpected by the product manufacturer, or unforeseeable and unanticipated [but] it was not the case that reasonable minds could only conclude that appellee misused the [hammer]. Though the plaintiff’s use of the hammer might have been *unreasonable*, unreasonable use is not a defense to a strict product-liability action or to a negligence action.”

Limited Remedy

The Restatement says recovery under strict liability is limited to “physical harm thereby caused to the ultimate user or consumer, or to his property,” but not other losses and not economic losses. In *Atlas Air v. General Electric*, a New York court held that the “economic loss rule” (no recovery for economic losses) barred strict products-liability and negligence claims by the purchaser of a used airplane against the airplane engine manufacturer for damage to the plane caused by an emergency landing necessitated by engine failure, where the purchaser merely alleged economic losses with respect to the plane itself, and not damages for personal injury (recovery for damage to the engine was allowed).*Atlas Air v. General Electric*, 16 A.D.3d 444 (N.Y.A.D. 2005).

But there are exceptions. In *Duffin v. Idaho Crop Imp. Ass'n*, the court recognized that a party generally owes no duty to exercise due care to avoid purely economic loss, but if there is a "special relationship" between the parties such that it would be equitable to impose such a duty, the duty will be imposed.*Duffin v. Idaho Crop Imp. Ass'n*, 895 P.2d 1195 (Idaho 1995). "In other words, there is an extremely limited group of cases where the law of negligence extends its protections to a party's economic interest."

The Third Restatement

The law develops. What seemed fitting in 1964 when the Restatement (Second) announced the state of the common-law rules for strict liability in Section 402A seemed, by 1997, not to be tracking common law entirely closely. The American Law Institute came out with the Restatement (Third) in that year. The Restatement changes some things. Most notably it abolishes the "unreasonably dangerous" test and substitutes a "risk-utility test." That is, a product is not defective unless its riskiness outweighs its utility. More important, the Restatement (Third), Section 2, now requires the plaintiff to provide a reasonable alternative design to the product in question. In advancing a reasonable alternative design, the plaintiff is not required to offer a prototype product. The plaintiff must only show that the proposed alternative design exists and is superior to the product in question. The Restatement (Third) also makes it more difficult for plaintiffs to sue drug companies successfully. One legal scholar commented as follows on the Restatement (Third):

The provisions of the Third Restatement, if implemented by the courts, will establish a degree of fairness in the products liability arena. If courts adopt the Third Restatement's elimination of the "consumer expectations test," this change alone will strip juries of the ability to render decisions based on potentially subjective, capricious and unscientific opinions that a particular product design is unduly dangerous based on its performance in a single incident. More important, plaintiffs will be required to propose a reasonable alternative design to the product in question. Such a requirement will force plaintiffs to prove that a better product design exists other than in the unproven and untested domain of their experts' imaginations.Quinlivan Wexler LLP, "The 3rd Restatement of Torts—Shaping the Future of Products Liability Law," June 1, 1999, accessed March 1, 2011, http://library.findlaw.com/1999/Jun/1/127691.html.

Of course some people put more faith in juries than is evident here. The new Restatement has been adopted by a few jurisdictions and some cases the adopting jurisdictions incorporate some of its ideas, but courts appear reluctant to abandon familiar precedent.

Key Takeaway

Because the doctrines of breach of warranty and negligence did not provide adequate relief to those suffering damages or injuries in products-liability cases, beginning in the 1960s courts developed a new tort theory: strict products liability, restated in the Second Restatement, section 402A. Basically the doctrine says that if goods sold are unreasonably dangerous or defective, the merchant-seller will be liable for the immediate property loss and personal injuries caused thereby. But there remain obstacles to recovery even under this expanded concept of liability: disclaimers of liability have not completely been dismissed, the plaintiff's conduct or changes to the goods may limit recovery, and—with some exceptions—the remedies available are limited to personal injury (and damage to the goods themselves); economic loss is not recoverable. Almost forty years of experience with the Second Restatement's section on strict liability has seen changes in the law, and the Third Restatement introduces those, but it has not been widely accepted yet.

Exercises

1. What was perceived to be inadequate about warranty and negligence theories that necessitated the development of strict liability?
2. Briefly describe the doctrine.
3. What defects in goods render their sellers strictly liable?
4. Who counts as a liable seller?
5. What obstacles does a plaintiff have to overcome here, and what limitations are there to recovery?

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10.6: Tort Reform

Learning Objectives

1. See why tort reform is advocated, why it is opposed, and what interests take each side.
2. Understand some of the significant state reforms in the last two decades.
3. Know what federal reforms have been instituted.

The Cry for Reform

In 1988, The Conference Board published a study that resulted from a survey of more than 500 chief executive officers from large and small companies regarding the effects of products liability on their firms. The study concluded that US companies are less competitive in international business because of these effects and that products-liability laws must be reformed. The reform effort has been under way ever since, with varying degrees of alarms and finger-pointing as to who is to blame for the "tort crisis," if there even is one. Business and professional groups beat the drums for tort reform as a means to guarantee "fairness" in the courts as well as spur US economic competitiveness in a global marketplace, while plaintiffs' attorneys and consumer advocates claim that businesses simply want to externalize costs by denying recovery to victims of greed and carelessness.

Each side vilifies the other in very unseemly language: probusiness advocates call consumer-oriented states "judicial hell-holes" and complain of "well-orchestrated campaign[s] by tort lawyer lobbyists and allies to undo years of tort reform at the state level,"American Tort Reform Association website, accessed March 1, 2011, http://www.atra.org. while pro-plaintiff interests claim that there is "scant evidence" of any tort abuse. www.shragerlaw.com/html/legal_rights.html. It would be more amusing if it were not so shrill and partisan. Perhaps the most one can say with any certainty is that peoples' perception of reality is highly colored by their self-interest. In any event, there have been reforms (or, as the detractors say, "deforms").

State Reforms

Prodded by astute lobbying by manufacturing and other business trade associations, state legislatures responded to the cries of manufacturers about the hardships that the judicial transformation of the products-liability lawsuit ostensibly worked on them. Most state legislatures have enacted at least one of some three dozen "reform" proposal pressed on them over the last two decades. Some of these measures do little more than affirm and clarify case law. Among the most that have passed in several states are outlined in the next sections.

Statutes of Repose

Perhaps nothing so frightens the manufacturer as the occasional reports of cases involving products that were fifty or sixty years old or more at the time they injured the plaintiff. Many states have addressed this problem by enacting the so-called **statute of repose**. This statute establishes a time period, generally ranging from six to twelve years; the manufacturer is not liable for injuries caused by the product after this time has passed.

State-of-the-Art Defense

Several states have enacted laws that prevent advances in technology from being held against the manufacturer. The fear is that a plaintiff will convince a jury a product was defective because it did not use technology that was later available. Manufacturers have often failed to adopt new advances in technology for fear that the change will be held against them in a products-liability suit. These new statutes declare that a manufacturer has a valid defense if it would have been technologically impossible to have used the new and safer technology at the time the product was manufactured.

Failure to Warn

Since it is often easier to prove that an injury resulted because the manufacturer failed to warn against a certain use than it is

to prove an injury was caused by a defective design, manufacturers are subjected to a considerable degree of hindsight. Some of the state statutes limit the degree to which the failure to warn can be used to connect the product and the injury. For example, the manufacturer has a valid defense if it would have been impossible to foresee that the consumer might misuse the product in a certain way.

Comparative Fault for Consumer Misuse

Contributory negligence is generally not a defense in a strict liability action, while assumption of risk is. In states that have enacted so-called comparative fault statutes, the user's damages are pegged to the percentage of responsibility for the injury that the defendant bears. Thus if the consumer's misuse of the product is assessed as having been 20 percent responsible for the accident (or for the extent of the injuries), the consumer is entitled to only 80 percent of damages, the amount for which the defendant manufacturer is responsible.

Criminal Penalties

Not all state reform is favorable to manufacturers. Under the California Corporate Criminal Liability Act, which took effect twenty years ago, companies and managers must notify a state regulatory agency if they know that a product they are selling in California has a safety defect, and the same rule applies under certain federal standards, as Toyota executives were informed by their lawyers following alarms about sudden acceleration in some Toyota automobiles. Failure to provide notice may result in corporate and individual criminal liability.

Federal Reform

Piecemeal reform of products-liability law in each state has contributed to the basic lack of uniformity from state to state, giving it a crazy-quilt effect. In the nineteenth century, this might have made little difference, but today most manufacturers sell in the national market and are subjected to the varying requirements of the law in every state. For years there has been talk in and out of Congress of enacting a federal products-liability law that would include reforms adopted in many states, as discussed earlier. So far, these efforts have been without much success.

Congressional tort legislation is not the only possible federal action to cope with products-related injuries. In 1972, Congress created the Consumer Product Safety Commission (CPSC) and gave the commission broad power to act to prevent unsafe consumer products. The CPSC can issue mandatory safety standards governing design, construction, contents, performance, packaging, and labeling of more than 10,000 consumer products. It can recall unsafe products, recover costs on behalf of injured consumers, prosecute those who violate standards, and require manufacturers to issue warnings on hazardous products. It also regulates four federal laws previously administered by other departments: the Flammable Fabrics Act, the Hazardous Substances Act, the Poison Prevention Packaging Act, and the Refrigerator Safety Act. In its early years, the CPSC issued standards for bicycles, power mowers, television sets, architectural glass, extension cords, book matches, pool slides, and space heaters. But the list of products is long, and the CPSC's record is mixed: it has come under fire for being short on regulation and for taking too long to promulgate the relatively few safety standards it has issued in a decade.

Key Takeaway

Business advocates claim the American tort system—products-liability law included—is broken and corrupted by grasping plaintiffs' lawyers; plaintiffs' lawyers say businesses are greedy and careless and need to be smacked into recognition of its responsibilities to be more careful. The debate rages on, decade after decade. But there have been some reforms at the state level, and at the federal level the Consumer Product Safety Act sets out standards for safe products and requires recalls for defective ones. It is regularly castigated for (1) being officious and meddling or (2) being too timid.

Exercises

1. Why is it so difficult to determine if there really is a "tort crisis" in the United States?
2. What reforms have been made to state tort law?
3. What federal legislation affects consumer safety?

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10.7: Cases

Implied Warranty of Merchantability and the Requirement of a “Sale”

Sheeskin v. Giant Food, Inc.

318 A.2d 874 (Md. App. 1974)

Davidson, J.

Every Friday for over two years Nathan Seigel, age 73, shopped with his wife at a Giant Food Store. This complex products liability case is before us because on one of these Fridays, 23 October 1970, Mr. Seigel was carrying a six-pack carton of Coca-Cola from a display bin at the Giant to a shopping cart when one or more of the bottles exploded. Mr. Seigel lost his footing, fell to the floor and was injured.

In the Circuit Court for Montgomery County, Mr. Seigel sued both the Giant Food, Inc., and the Washington Coca-Cola Bottling Company, Inc., for damages resulting from their alleged negligence and breach of an implied warranty. At the conclusion of the trial Judge Walter H. Moorman directed a verdict in favor of each defendant....

In an action based on breach of warranty it is necessary for the plaintiff to show the existence of the warranty, the fact that the warranty was broken and that the breach of warranty was the proximate cause of the loss sustained. [UCC] 2-314....The retailer, Giant Food, Inc., contends that appellant failed to prove that an implied warranty existed between himself and the retailer because he failed to prove that there was a sale by the retailer to him or a contract of sale between the two. The retailer maintains that there was no sale or contract of sale because at the time the bottles exploded Mr. Seigel had not yet paid for them. We do not agree.

[UCC] 2-314(1) states in pertinent part:

Unless excluded or modified, a warranty that the goods shall be merchantable is implied **in a contract for their sale** if the seller is a merchant with respect to goods of that kind.Uniform Commercial Code, Section 2-316. (emphasis added)

Thus, in order for the implied warranties of 2-314 to be applicable there must be a “contract for sale.” In Maryland it has been recognized that neither a completed ‘sale’ nor a fully executed contract for sale is required. It is enough that there be in existence an executory contract for sale....

Here, the plaintiff has the burden of showing the existence of the warranty by establishing that at the time the bottles exploded there was a contract for their sale existing between himself and the Giant. [Citation] Mr. Titus, the manager of the Giant, testified that the retailer is a “self-service” store in which “the only way a customer can buy anything is to select it himself and take it to the checkout counter.” He stated that there are occasions when a customer may select an item in the store and then change his mind and put the item back. There was no evidence to show that the retailer ever refused to sell an item to a customer once it had been selected by him or that the retailer did not consider himself bound to sell an item to the customer after the item had been selected. Finally, Mr. Titus said that an employee of Giant placed the six-pack of Coca-Cola selected by Mr. Seigel on the shelf with the purchase price already stamped upon it. Mr. Seigel testified that he picked up the six-pack with the intent to purchase it.

We think that there is sufficient evidence to show that the retailer’s act of placing the bottles upon the shelf with the price stamped upon the six-pack in which they were contained manifested an intent to offer them for sale, the terms of the offer being that it would pass title to the goods when Mr. Seigel presented them at the check-out counter and paid the stated price in cash. We also think that the evidence is sufficient to show that Mr. Seigel’s act of taking physical possession of the goods with the intent to purchase them manifested an intent to accept the offer and a promise to take them to the checkout counter and pay for them there.

[UCC] 2-206 provides in pertinent part:

(1) Unless otherwise unambiguously indicated by the language or circumstances

(a) An offer to make a contract shall be construed as inviting acceptance in any manner and by any medium reasonable in the

circumstances....

The Official Comment 1 to this section states:

Any reasonable manner of acceptance is intended to be regarded as available unless the offeror has made quite clear that it will not be acceptable.

In our view the manner by which acceptance was to be accomplished in the transaction herein involved was not indicated by either language or circumstances. The seller did not make it clear that acceptance could not be accomplished by a promise rather than an act. Thus it is equally reasonable under the terms of this specific offer that acceptance could be accomplished in any of three ways: 1) by the act of delivering the goods to the check-out counter and paying for them; 2) by the promise to pay for the goods as evidenced by their physical delivery to the check-out counter; and 3) by the promise to deliver the goods to the check-out counter and to pay for them there as evidenced by taking physical possession of the goods by their removal from the shelf.

The fact that customers, having once selected goods with the intent to purchase them, are permitted by the seller to return them to the shelves does not preclude the possibility that a selection of the goods, as evidenced by taking physical possession of them, could constitute a reasonable mode of acceptance. Section 2-106(3) provides:

"Termination" occurs when either party pursuant to a power created by agreement or law puts an end to the contract otherwise then for its breach. On "termination" all obligations which are still executory on both sides are discharged but any right based on prior breach or performance survives.

Here the evidence that the retailer permits the customer to "change his mind" indicates only an agreement between the parties to permit the consumer to end his contract with the retailer irrespective of a breach of the agreement by the retailer. It does not indicate that an agreement does not exist prior to the exercise of this option by the consumer....

Here Mr. Seigel testified that all of the circumstances surrounding his selection of the bottles were normal; that the carton in which the bottles came was not defective; that in lifting the carton from the shelf and moving it toward his basket the bottles neither touched nor were touched by anything other than his hand; that they exploded almost instantaneously after he removed them from the shelf; and that as a result of the explosion he fell injuring himself. It is obvious that Coca-Cola bottles which would break under normal handling are not fit for the ordinary use for which they were intended and that the relinquishment of physical control of such a defective bottle to a consumer constitutes a breach of warranty. Thus the evidence was sufficient to show that when the bottles left the retailer's control they did not conform to the representations of the warranty of merchantability, and that this breach of the warranty was the cause of the loss sustained....

[Judgment in favor of Giant Foods is reversed and the case remanded for a new trial. Judgment in favor of the bottler is affirmed because the plaintiff failed to prove that the bottles were defective when they were delivered to the retailer.]

CASE QUESTIONS

1. What warranty did the plaintiff complain was breached here?
2. By displaying the soda pop, the store made an offer to its customers. How did the court say such offers might be accepted?
3. Why did the court get into the discussion about "termination" of the contract?
4. What is the controlling rule of law applied in this case?

Strict Liability and Bystanders

Embs v. Pepsi-Cola Bottling Co. of Lexington, Kentucky, Inc.

528 S.W.2d 703 (Ky. 1975)

Jukowsky, J.

On the afternoon of July 25, 1970 plaintiff-appellant entered the self-service retail store operated by the defendant-appellee, Stamper's Cash Market, Inc., for the purpose of "buying soft drinks for the kids." She went to an upright soft drink cooler, removed five bottles and placed them in a carton. Unnoticed by her, a carton of Seven-Up was sitting on the floor at the edge of the produce counter about one foot from where she was standing. As she turned away from the cooler she heard an explosion that

sounded “like a shotgun.” When she looked down she saw a gash in her leg, pop on her leg, green pieces of a bottle on the floor and the Seven-Up carton in the midst of the debris. She did not kick or otherwise come into contact with the carton of Seven-Up prior to the explosion. Her son, who was with her, recognized the green pieces of glass as part of a Seven-Up bottle.

She was immediately taken to the hospital by Mrs. Stamper, a managing agent of the store. Mrs. Stamper told her that a Seven-Up bottle had exploded and that several bottles had exploded that week. Before leaving the store Mrs. Stamper instructed one of her children to clean up the mess. Apparently, all of the physical evidence went out with the trash. The location of the Seven-Up carton immediately before the explosion was not a place where such items were ordinarily kept....

When she rested her case, the defendants-appellees moved for a directed verdict in their favor. The trial court granted the motion on the grounds that the doctrine of strict product liability in tort does not extend beyond users and consumers and that the evidence was insufficient to permit an inference by a reasonably prudent man that the bottle was defective or if it was, when it became so.

In [Citation] we adopted the view of strict product liability in tort expressed in Section 402 A of the American Law Institute’s Restatement of Torts 2d.

402 A. Special Liability of Seller of Product for Physical Harm to User or Consumer

(1) One who sells any product in a defective condition unreasonably dangerous to the user or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or to his property, if

(a) the seller is engaged in the business of selling such a product, and

(b) it is expected to and does reach the user or consumer without substantial change in the condition in which it was sold.

(2) The rule stated in Subsection (1) applies although

(a) the seller has exercised all possible care in the preparation and sale of his product, and

(b) the user or consumer has not bought the product from or entered into any contractual relation with the seller.

Comment *f* on that section makes it abundantly clear that this rule applies to any person engaged in the business of supplying products for use or consumption, including any manufacturer of such a product and any wholesale or retail dealer or distributor.

Comment *c* points out that on whatever theory, the justification for the rule has been said to be that the seller, by marketing his product for use and consumption, has undertaken and assumed a special responsibility toward any member of the consuming public who may be injured by it; that the public has the right to and does expect that reputable sellers will stand behind their goods; that public policy demands that the burden of accidental injuries caused by products intended for consumption be placed upon those who market them, and be treated as a cost of production against which liability insurance can be obtained; and that the consumer of such products is entitled to the maximum of protection at the hands of someone, and the proper persons to afford it are those who market the products.

The caveat to the section provides that the Institute expresses no opinion as to whether the rule may not apply to harm to persons other than users or consumers. Comment on caveat *o* states the Institute expresses neither approval nor disapproval of expansion of the rule to permit recovery by casual bystanders and others who may come in contact with the product, and admits there may be no essential reason why such plaintiffs should not be brought within the scope of protection afforded, other than they do not have the same reasons for expecting such protection as the consumer who buys a marketed product, and that the social pressure which has been largely responsible for the development of the rule has been a consumer’s pressure, and there is not the same demand for the protection of casual strangers....

The caveat articulates the essential point: Once strict liability is accepted, bystander recovery is fait accompli.

Our expressed public policy will be furthered if we minimize the risk of personal injury and property damage by charging the costs of injuries against the manufacturer who can procure liability insurance and distribute its expense among the public as a cost of doing business; and since the risk of harm from defective products exists for mere bystanders and passersby as well as for the purchaser or user, there is no substantial reason for protecting one class of persons and not the other. The same policy requires us to maximize protection for the injured third party and promote the public interest in discouraging the marketing of products having defects that are a menace to the public by imposing strict liability upon retailers and wholesalers in the

distributive chain responsible for marketing the defective product which injures the bystander. The imposition of strict liability places no unreasonable burden upon sellers because they can adjust the cost of insurance protection among themselves in the course of their continuing business relationship.

We must not shirk from extending the rule to the manufacturer for fear that the retailer or middleman will be impaled on the sword of liability without regard to fault. Their liability was already established under Section 402 A of the Restatement of Torts 2d. As a matter of public policy the retailer or middleman as well as the manufacturer should be liable since the loss for injuries resulting from defective products should be placed on those members of the marketing chain best able to pay the loss, who can then distribute such risk among themselves by means of insurance and indemnity agreements. [Citation]...

The result which we reach does not give the bystander a "free ride." When products and consumers are considered in the aggregate, bystanders, as a class, purchase most of the same products to which they are exposed as bystanders. Thus, as a class, they indirectly subsidize the liability of the manufacturer, middleman and retailer and in this sense do pay for the insurance policy tied to the product....

For the sake of clarity we restate the extension of the rule. The protections of Section 402 A of the Restatement of Torts 2d extend to bystanders whose injury from the defective product is reasonably foreseeable....

The judgment is reversed and the cause is remanded to the Clark Circuit Court for further proceedings consistent herewith.

Stephenson, J. (dissenting):

I respectfully dissent from the majority opinion to the extent that it subjects the seller to liability. Every rule of law in my mind should have a rational basis. I see none here.

Liability of the seller to the user, or consumer, is based upon warranty. Restatement, Second, Torts s 403A. To extend this liability to injuries suffered by a bystander is to depart from any reasonable basis and impose liability by judicial fiat upon an otherwise innocent defendant. I do not believe that the expression in the majority opinion which justifies this rule for the reason that the seller may procure liability insurance protection is a valid legal basis for imposing liability without fault. I respectfully dissent.

CASE QUESTIONS

1. Why didn't the plaintiff here use warranty as a theory of recovery, as Mr. Seigel did in the previous case?
2. The court offers a rationale for the doctrine of strict products liability. What is it?
3. Restatement, Section 402A, by its terms extends protection "to the ultimate user or consumer," but Mrs. Embs [plaintiff-appellant] was not that. What rationale did the court give for expanding the protection here?
4. Among the entities in the vertical distribution chain—manufacturer, wholesaler, retailer—who is liable under this doctrine?
5. What argument did Judge Stephenson have in dissent? Is it a good one?
6. What is the controlling rule of law developed in this case?

Failure to Warn

Laaperi v. Sears, Roebuck & Co., Inc.

787 F.2d 726 C.A.1 (Mass. 1986)

Campbell, J.

In March 1976, plaintiff Albin Laaperi purchased a smoke detector from Sears. The detector, manufactured by the Pittway Corporation, was designed to be powered by AC (electrical) current. Laaperi installed the detector himself in one of the two upstairs bedrooms in his home.

Early in the morning of December 27, 1976, a fire broke out in the Laaperi home. The three boys in one of the upstairs bedrooms were killed in the blaze. Laaperi's 13-year-old daughter Janet, who was sleeping in the other upstairs bedroom, received burns over 12 percent of her body and was hospitalized for three weeks.

The uncontroverted testimony at trial was that the smoke detector did not sound an alarm on the night of the fire. The cause of the fire was later found to be a short circuit in an electrical cord that was located in a cedar closet in the boys' bedroom. The

Laaperi home had two separate electrical circuits in the upstairs bedrooms: one which provided electricity to the outlets and one which powered the lighting fixtures. The smoke detector had been connected to the outlet circuit, which was the circuit that shorted and cut off. Because the circuit was shorted, the AC-operated smoke detector received no power on the night of the fire. Therefore, although the detector itself was in no sense defective (indeed, after the fire the charred detector was tested and found to be operable), no alarm sounded.

Laaperi brought this diversity action against defendants Sears and Pittway, asserting negligent design, negligent manufacture, breach of warranty, and negligent failure to warn of inherent dangers. The parties agreed that the applicable law is that of Massachusetts. Before the claims went to the jury, verdicts were directed in favor of defendants on all theories of liability other than failure to warn....

Laaperi's claim under the failure to warn theory was that he was unaware of the danger that the very short circuit which might ignite a fire in his home could, at the same time, incapacitate the smoke detector. He contended that had he been warned of this danger, he would have purchased a battery-powered smoke detector as a back-up or taken some other precaution, such as wiring the detector to a circuit of its own, in order better to protect his family in the event of an electrical fire.

The jury returned verdicts in favor of Laaperi in all four actions on the failure to warn claim. The jury assessed damages in the amount of $350,000 [$1,050,000, or about $3,400,000 in 2010 dollars] each of the three actions brought on behalf of the deceased sons, and $750,000 [about $2,500,000 in 2010 dollars] in the action brought on behalf of Janet Laaperi. The defendants' motions for directed verdict and judgment notwithstanding the verdict were denied, and defendants appealed.

Defendants ask us to declare that the risk that an electrical fire could incapacitate an AC-powered smoke detector is so obvious that the average consumer would not benefit from a warning. This is not a trivial argument; in earlier—some might say sounder—days, we might have accepted it.... Our sense of the current state of the tort law in Massachusetts and most other jurisdictions, however, leads us to conclude that, today, the matter before us poses a jury question; that "obviousness" in a situation such as this would be treated by the Massachusetts courts as presenting a question of fact, not of law. To be sure, it would be obvious to anyone that an electrical outage would cause this smoke detector to fail. But the average purchaser might not comprehend the specific danger that a fire-causing electrical problem can simultaneously knock out the circuit into which a smoke detector is wired, causing the detector to fail at the very moment it is needed. Thus, while the failure of a detector to function as the result of an electrical malfunction due, say, to a broken power line or a neighborhood power outage would, we think, be obvious as a matter of law, the failure that occurred here, being associated with the very risk—fire—for which the device was purchased, was not, or so a jury could find....

Finally, defendants contend that the award of $750,000 [$2.5 million in 2010 dollars] in damages to Janet Laaperi was excessive, and should have been overturned by the district court....

Janet Laaperi testified that on the night of the fire, she woke up and smelled smoke. She woke her friend who was sleeping in her room, and they climbed out to the icy roof of the house. Her father grabbed her from the roof and took her down a ladder. She was taken to the hospital. Although she was in "mild distress," she was found to be "alert, awake, [and] cooperative." Her chest was clear. She was diagnosed as having first and second degree burns of her right calf, both buttocks and heels, and her left lower back, or approximately 12 percent of her total body area. She also suffered from a burn of her tracheobronchial mucosa (i.e., the lining of her airway) due to smoke inhalation, and multiple superficial lacerations on her right hand.

The jury undoubtedly, and understandably, felt a great deal of sympathy for a young girl who, at the age of 13, lost three brothers in a tragic fire. But by law the jury was only permitted to compensate her for those damages associated with her own injuries. Her injuries included fright and pain at the time of and after the fire, a three-week hospital stay, some minor discomfort for several weeks after discharge, and a permanent scar on her lower back. Plaintiff has pointed to no cases, and we have discovered none, in which such a large verdict was sustained for such relatively minor injuries, involving no continuing disability.

The judgments in favor of Albin Laaperi in his capacity as administrator of the estates of his three sons are affirmed. In the action on behalf of Janet Laaperi, the verdict of the jury is set aside, the judgment of the district court vacated, and the cause remanded to that court for a new trial limited to the issue of damages.

CASE QUESTIONS

1. The "C.A. 1" under the title of the case means it is a US Court of Appeals case from the First Circuit in Massachusetts. Why is this case in federal court?
2. Why does the court talk about its "sense of the current state of tort law in Massachusetts" and how this case "would be

treated by the Massachusetts courts," as if it were not in the state at all but somehow outside?
3. What rule of law is in play here as to the defendants' liability?
4. This is a tragic case—three boys died in a house fire. Speaking dispassionately—if not heartlessly—though, did the fire actually cost Mr. Laaperi, or did he lose $3.4 million (in 2010 dollars) as the result of his sons' deaths? Does it make sense that he should become a millionaire as a result? Who ends up paying this amount? (The lawyers' fees probably took about half.)
5. Is it likely that smoke-alarm manufactures and sellers changed the instructions as a result of this case?

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10.8: Summary and Exercises

Summary

Products liability describes a type of claim—for injury caused by a defective product—and not a separate theory of liability. In the typical case, three legal doctrines may be asserted: (1) warranty, (2) negligence, and (3) strict liability.

If a seller asserts that a product will perform in a certain manner or has certain characteristics, he has given an express warranty, and he will be held liable for damages if the warranty is breached—that is, if the goods do not live up to the warranty. Not every conceivable claim is an express warranty; the courts permit a certain degree of "puffing."

An implied warranty is one created by law. Goods sold by a merchant-seller carry an implied warranty of merchantability, meaning that they must possess certain characteristics, such as being of average quality for the type described and being fit for the ordinary purposes for which they are intended.

An implied warranty of fitness for a particular purpose is created whenever a seller knows or has reason to know that the buyer is relying on the seller's knowledge and skill to select a product for the buyer's particular purposes.

Under UCC Article 2, the seller also warrants that he is conveying good title and that the goods are free of any rightful claim by a third person.

UCC Article 2 permits sellers to exclude or disclaim warranties in whole or in part. Thus a seller may exclude express warranties. He may also disclaim many implied warranties—for example, by noting that the sale is "as is." The Magnuson-Moss Act sets out certain types of information that must be included in any written warranty. The act requires the manufacturer or seller to label the warranty as either "full" or "limited" depending on what types of defects are covered and what the customer must do to obtain repair or replacement. The act also abolishes "phantom warranties."

Privity once stood as a bar to recovery in suits brought by those one or more steps removed in the distribution chain from the party who breached a warranty. But the nearly universal trend in the state courts has been to abolish privity as a defense.

Because various impediments stand in the way of warranty suits, courts have adopted a tort theory of strict liability, under which a seller is liable for injuries resulting from the sale of any product in a defective condition if it is unreasonably dangerous to the user or consumer. Typical issues in strict liability cases are these: Is the defendant a seller engaged in the business of selling? Was the product sold in a defective condition? Was it unreasonably dangerous, either on its face or because of a failure to warn? Did the product reach the consumer in an unchanged condition? Strict liability applies regardless of how careful the seller was and regardless of his lack of contractual relation with the consumer or user.

Manufacturers can also be held liable for negligence—most often for faulty design of products and inadequate warnings about the hazards of using the product.

The products-liability revolution prompted many state legislatures to enact certain laws limiting to some degree the manufacturer's responsibility for defective products. These laws include statutes of repose and provide a number of other defenses.

Exercises

1. Ralph's Hardware updated its accounting system and agreed to purchase a computer system from a manufacturer, Bits and Bytes (BB). During contract negotiations, BB's sales representative promised that the system was "A-1" and "perfect." However, the written contract, which the parties later signed, disclaimed all warranties, express and implied. After installation the computer produced only random numbers and letters, rather than the desired accounting information. Is BB liable for breaching an express warranty? Why?
2. Kate owned a small grocery store. One day John went to the store and purchased a can of chip dip that was, unknown to Kate or John, adulterated. John became seriously ill after eating the dip and sued Kate for damages on the grounds that she breached an implied warranty of merchantability. Is Kate liable? Why?
3. Carrie visited a neighborhood store to purchase some ham, which a salesperson cut by machine in the store. The next day

she made a ham sandwich. In eating the sandwich, Carrie bit into a piece of cartilage in the ham. As a result, Carrie lost a tooth, had to undergo root canal treatments, and must now wear a full-coverage crown to replace the tooth. Is the store liable for the damage? Why?

4. Clarence, a business executive, decided to hold a garage sale. At the sale, his neighbor Betty mentioned to Clarence that she was the catcher on her city-league baseball team and was having trouble catching knuckleball pitches, which required a special catcher's mitt. Clarence pulled an old mitt from a pile of items that were on sale and said, "Here, try this." Betty purchased the mitt but discovered during her next game that it didn't work. Has Clarence breached an express or implied warranty? Why?
5. Sarah purchased several elegant picture frames to hang in her dorm room. She also purchased a package of self-sticking hangers. Late one evening, while Sarah was studying business law in the library, the hangers came loose and her frames came crashing to the floor. After Sarah returned to her room and discovered the rubble, she examined the box in which the hangers were packaged and found the following language: "There are no warranties except for the description on this package and specifically there is NO IMPLIED WARRANTY OF MERCHANTABILITY." Assuming the hangers are not of fair, average, ordinary quality, would the hanger company be liable for breaching an implied warranty of merchantability? Why?
6. A thirteen-year-old boy received a Golfing Gizmo—a device for training novice golfers—as a gift from his mother. The label on the shipping carton and the cover of the instruction booklet urged players to "drive the ball with full power" and further stated: "COMPLETELY SAFE BALL WILL NOT HIT PLAYER." But while using the device, the boy was hit in the eye by the ball. Should lack of privity be a defense to the manufacturer? The manufacturer argued that the Gizmo was a "completely safe" training device only when the ball is hit squarely, and—the defendant argued—plaintiffs could not reasonably expect the Gizmo to be "completely safe" under all circumstances, particularly those in which the player hits beneath the ball. What legal argument is this, and is it valid?
7. A bank repossessed a boat and sold it to Donald. During the negotiations with Donald, Donald stated that he wanted to use the boat for charter service in Florida. The bank officers handling the sale made no representations concerning the boat during negotiations. Donald later discovered that the boat was defective and sued the bank for breach of warranty. Is the bank liable? Why?
8. Tom Anderson, the produce manager at the Thriftway Market in Pasco, Washington, removed a box of bananas from the top of a stack of produce. When he reached for a lug of radishes that had been under the bananas, a six-inch spider—*Heteropoda venatoria*, commonly called a banana spider—leaped from some wet burlap onto his left hand and bit him. Nine months later he died of heart failure. His wife brought an action against Associated Grocers, parent company of Thriftway Market, on theories of (1) strict products liability under Restatement, Section 402(a); (2) breach of the implied warranty of merchantability; and (3) negligence. The trial court ruled against the plaintiff on all three theories. Was that a correct ruling? Explain.
9. A broken water pipe flooded a switchboard at RCA's office. The flood tripped the switchboard circuit breakers and deactivated the air-conditioning system. Three employees were assigned to fix it: an electrical technician with twelve years on-the-job training, a licensed electrician, and an electrical engineer with twenty years of experience who had studied power engineering in college. They switched on one of the circuit breakers, although the engineer said he knew that one was supposed to test the operation of a wet switchboard before putting it back into use. There was a "snap" and everyone ran from the room up the stairs and a "big ball of fire" came after them up the stairs. The plaintiffs argued that the manufacturer of the circuit breaker had been negligent in failing to give RCA adequate warnings about the circuit breakers. How should the court rule, and on what theory should it rule?
10. Plaintiff's business was to convert vans to RVs, and for this purpose it had used a 3M adhesive to laminate carpeting to the van walls. This adhesive, however, failed to hold the fabric in place in hot weather, so Plaintiff approached Northern Adhesive Co., a manufacturer of adhesives, to find a better one. Plaintiff told Northern why it wanted the adhesive, and Northern—Defendant—sent several samples to Plaintiff to experiment with. Northern told Plaintiff that one of the adhesives, Adhesive 7448, was "a match" for the 3M product that previously failed. Plaintiff tested the samples in a cool plant and determined that Adhesive 7448 was better than the 3M product. Defendant had said nothing except that "what they would ship would be like the sample. It would be the same chemistry." Plaintiff used the adhesive during the fall and winter; by spring complaints of delamination came in: Adhesive 7448 failed just as the 3M product had. Over 500 vans had to be repaired. How should the court rule on Plaintiff's claims of breach of (1) express warranty, (2) implied warranty of merchantability, and (3) implied warranty of fitness for a particular purpose?

SELF-TEST QUESTIONS

1. In a products-liability case a. only tort theories are typically asserted
   b. both tort and contract theories are typically asserted
   c. strict liability is asserted only when negligence is not asserted
   d. breach of warranty is not asserted along with strict liability

2. An implied warranty of merchantability a. is created by an express warranty
   b. is created by law
   c. is impossible for a seller to disclaim
   d. can be disclaimed by a seller only if the disclaimer is in writing
3. A possible defense to breach of warranty is a. lack of privity
   b. absence of an express warranty
   c. disclaimer of implied warranties
   d. all of the above
4. Under the strict liability rule in Restatement, Section 402A, the seller is liable for all injuries resulting from a product a. even though all possible care has been exercised
   b. regardless of the lack of a contract with the user
   c. in both of the above situations
   d. in none of the above situations
5. An individual selling her car could be liable a. for breaching the implied warranty of merchantability
   b. under the strict liability theory
   c. for breaching the implied warranty of fitness
   d. under two of the above

SELF-TEST AnswerS

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

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11: ADMINISTRATIVE LAW

11.1: Administrative Agencies - Their Structure and Powers
11.2: Controlling Administrative Agencies
11.3: The Administrative Procedure Act
11.4: Administrative Burdens on Business Operations
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11.1: Administrative Agencies - Their Structure and Powers

Learning Objectives

1. Explain the reasons why we have federal administrative agencies.
2. Explain the difference between executive branch agencies and independent agencies.
3. Describe the constitutional issue that questions whether administrative agencies could have authority to make enforceable rules that affect business.

Why Have Administrative Agencies?

The US Constitution mentions only three branches of government: legislative, executive, and judicial (Articles I, II, and III). There is no mention of agencies in the Constitution, even though federal agencies are sometimes referred to as "the fourth branch of government." The Supreme Court has recognized the legitimacy of federal **administrative agencies** to make rules that have the same binding effect as statutes by Congress.

Most commentators note that having agencies with rule-making power is a practical necessity: (1) Congress does not have the expertise or continuity to develop specialized knowledge in various areas (e.g., communications, the environment, aviation). (2) Because of this, it makes sense for Congress to set forth broad statutory guidance to an agency and delegate authority to the agency to propose rules that further the statutory purposes. (3) As long as Congress makes this delegating guidance sufficiently clear, it is not delegating improperly. If Congress's guidelines are too vague or undefined, it is (in essence) giving away its constitutional power to some other group, and this it cannot do.

Why Regulate the Economy at All?

The market often does not work properly, as economists often note. Monopolies, for example, happen in the natural course of human events but are not always desirable. To fix this, well-conceived and objectively enforced competition law (what is called antitrust law in the United States) is needed.

Negative externalities must be "fixed," as well. For example, as we see in tort law (Chapter 7 "Introduction to Tort Law"), people and business organizations often do things that impose costs (damages) on others, and the legal system will try—through the award of compensatory damages—to make fair adjustments. In terms of the ideal conditions for a free market, think of tort law as the legal system's attempt to compensate for negative externalities: those costs imposed on people who have not voluntarily consented to bear those costs.

In terms of freedoms to enter or leave the market, the US constitutional guarantees of equal protection can prevent local, state, and federal governments from imposing discriminatory rules for commerce that would keep minorities, women, and gay people from full participation in business. For example, if the small town of Xenophobia, Colorado, passed a law that required all business owners and their employees to be Christian, heterosexual, and married, the equal protection clause (as well as numerous state and federal equal opportunity employment laws) would empower plaintiffs to go to court and have the law struck down as unconstitutional.

Knowing that information is power, we will see many laws administered by regulatory agencies that seek to level the playing field of economic competition by requiring disclosure of the most pertinent information for consumers (consumer protection laws), investors (securities laws), and citizens (e.g., the toxics release inventory laws in environmental law).

ideal conditions for a free market

1. There are many buyers and many sellers, and none of them has a substantial share of the market.
2. All buyers and sellers in the market are free to enter the market or leave it.

3. All buyers and all sellers have full and perfect knowledge of what other buyers and sellers are up to, including knowledge of prices, quantity, and quality of all goods being bought or sold.
4. The goods being sold in the market are similar enough to each other that participants do not have strong preferences as to which seller or buyer they deal with.
5. The costs and benefits of making or using the goods that are exchanged in the market are borne only by those who buy or sell those goods and not by third parties or people "external" to the market transaction. (That is, there are no "externalities.")
6. All buyers and sellers are utility maximizers; each participant in the market tries to get as much as possible for as little as possible.
7. There are no parties, institutions, or governmental units regulating the price, quantity, or quality of any of the goods being bought and sold in the market.

In short, some forms of legislation and regulation are needed to counter a tendency toward consolidation of economic power and discriminatory attitudes toward certain individuals and groups (Chapter 30 "Employment Law") and to insist that people and companies clean up their own messes and not hide information that would empower voluntary choices in the free market.

But there are additional reasons to regulate. For example, in economic systems, it is likely for natural monopolies to occur. These are where one firm can most efficiently supply all of the good or service. Having duplicate (or triplicate) systems for supplying electricity, for example, would be inefficient, so most states have a public utilities commission to determine both price and quality of service. This is direct regulation.

Sometimes destructive competition can result if there is no regulation. Banking and insurance are good examples of this. Without government regulation of banks (setting standards and methods), open and fierce competition would result in widespread bank failures. That would erode public confidence in banks and business generally. The current situation (circa 2011) of six major banks that are "too big to fail" is, however, an example of destructive *noncompetition*.

Other market imperfections can yield a demand for regulation. For example, there is a need to regulate frequencies for public broadcast on radio, television, and other wireless transmissions (for police, fire, national defense, etc.). Many economists would also list an adequate supply of public goods as something that must be created by government. On its own, for example, the market would not provide public goods such as education, a highway system, lighthouses, a military for defense.

True laissez-faire capitalism—a market free from any regulation—would not try to deal with market imperfections and would also allow people to freely choose products, services, and other arrangements that historically have been deemed socially unacceptable. These would include making enforceable contracts for the sale and purchase of persons (slavery), sexual services, "street drugs" such as heroin or crack cocaine, votes for public office, grades for this course in business law, and even marriage partnership.

Thus the free market in actual terms—and not in theory—consists of commerce legally constrained by what is economically desirable and by what is socially desirable as well. Public policy objectives in the social arena include ensuring equal opportunity in employment, protecting employees from unhealthy or unsafe work environments, preserving environmental quality and resources, and protecting consumers from unsafe products. Sometimes these objectives are met by giving individuals statutory rights that can be used in bringing a complaint (e.g., Title VII of the Civil Rights Act of 1964, for employment discrimination), and sometimes they are met by creating agencies with the right to investigate and monitor and enforce statutory law and regulations created to enforce such law (e.g., the Environmental Protection Agency, for bringing a lawsuit against a polluting company).

History of Federal Agencies

Through the commerce clause in the US Constitution, Congress has the power to regulate trade between the states and with foreign nations. The earliest federal agency therefore dealt with trucking and railroads, to literally set the rules of the road for interstate commerce. The first federal agency, the Interstate Commerce Commission (ICC), was created in 1887. Congress delegated to the ICC the power to enforce federal laws against railroad rate discrimination and other unfair pricing practices. By the early part of this century, the ICC gained the power to fix rates. From the 1970s through 1995, however, Congress passed deregulatory measures, and the ICC was formally abolished in 1995, with its powers transferred to the Surface Transportation Board.

Beginning with the Federal Trade Commission (FTC) in 1914, Congress has created numerous other agencies, many of them familiar actors in American government. Today more than eighty-five federal agencies have jurisdiction to regulate some form of

private activity. Most were created since 1930, and more than a third since 1960. A similar growth has occurred at the state level. Most states now have dozens of regulatory agencies, many of them overlapping in function with the federal bodies.

Classification of Agencies

Independent agencies are different from federal executive departments and other executive agencies by their structural and functional characteristics. Most executive departments have a single director, administrator, or secretary appointed by the president of the United States. Independent agencies almost always have a commission or board consisting of five to seven members who share power over the agency. The president appoints the commissioners or board subject to Senate confirmation, but they often serve with staggered terms and often for longer terms than a usual four-year presidential term. They cannot be removed except for "good cause." This means that most presidents will not get to appoint all the commissioners of a given independent agency. Most independent agencies have a statutory requirement of bipartisan membership on the commission, so the president cannot simply fill vacancies with members of his own political party.

In addition to the ICC and the FTC, the major independent agencies are the Federal Communications Commission (1934), Securities and Exchange Commission (1934), National Labor Relations Board (1935), and Environmental Protection Agency (1970). See Note 5.4 "Ideal Conditions for a Free Market" in the sidebar.

By contrast, members of executive branch agencies serve at the pleasure of the president and are therefore far more amenable to political control. One consequence of this distinction is that the rules that independent agencies promulgate may not be reviewed by the president or his staff—only Congress may directly overrule them—whereas the White House or officials in the various cabinet departments may oversee the work of the agencies contained within them (unless specifically denied the power by Congress).

Powers of Agencies

Agencies have a variety of powers. Many of the original statutes that created them, like the Federal Communications Act, gave them licensing power. No party can enter into the productive activity covered by the act without prior license from the agency—for example, no utility can start up a nuclear power plant unless first approved by the Nuclear Regulatory Commission. In recent years, the move toward deregulation of the economy has led to diminution of some licensing power. Many agencies also have the authority to set the rates charged by companies subject to the agency's jurisdiction. Finally, the agencies can regulate business practices. The FTC has general jurisdiction over all business in interstate commerce to monitor and root out "unfair acts" and "deceptive practices." The Securities and Exchange Commission (SEC) oversees the issuance of corporate securities and other investments and monitors the practices of the stock exchanges.

Unlike courts, administrative agencies are charged with the responsibility of carrying out a specific assignment or reaching a goal or set of goals. They are not to remain neutral on the various issues of the day; they must act. They have been given legislative powers because in a society growing ever more complex, Congress does not know how to legislate with the kind of detail that is necessary, nor would it have the time to approach all the sectors of society even if it tried. Precisely because they are to do what general legislative bodies cannot do, agencies are specialized bodies. Through years of experience in dealing with similar problems they accumulate a body of knowledge that they can apply to accomplish their statutory duties.

All administrative agencies have two different sorts of personnel. The heads, whether a single administrator or a collegial body of commissioners, are political appointees and serve for relatively limited terms. Below them is a more or less permanent staff—the bureaucracy. Much policy making occurs at the staff level, because these employees are in essential control of gathering facts and presenting data and argument to the commissioners, who wield the ultimate power of the agencies.

The Constitution and Agencies

Congress can establish an agency through legislation. When Congress gives powers to an agency, the legislation is known as an **enabling act**. The concept that Congress can delegate power to an agency is known as the **delegation doctrine**. Usually, the agency will have all three kinds of power: executive, legislative, and judicial. (That is, the agency can set the rules that business must comply with, can investigate and prosecute those businesses, and can hold administrative hearings for violations of those rules. They are, in effect, rule maker, prosecutor, and judge.) Because agencies have all three types of governmental powers, important constitutional questions were asked when Congress first created them. The most important question was whether Congress was giving away its legislative power. Was the separation of powers violated if agencies had power to make rules that

were equivalent to legislative statutes?

In 1935, in *Schechter Poultry Corp. v. United States*, the Supreme Court overturned the National Industrial Recovery Act on the ground that the congressional delegation of power was too broad.*Schechter Poultry Corp. v. United States*, 295 US 495 (1935). Under the law, industry trade groups were granted the authority to devise a code of fair competition for the entire industry, and these codes became law if approved by the president. No administrative body was created to scrutinize the arguments for a particular code, to develop evidence, or to test one version of a code against another. Thus it was unconstitutional for the Congress to transfer all of its legislative powers to an agency. In later decisions, it was made clear that Congress could delegate some of its legislative powers, but only if the delegation of authority was not overly broad.

Still, some congressional enabling acts are very broad, such as the enabling legislation for the Occupational Safety and Health Administration (OSHA), which is given the authority to make rules to provide for safe and healthful working conditions in US workplaces. Such a broad initiative power gives OSHA considerable discretion. But, as noted in Section 5.2 "Controlling Administrative Agencies", there are both executive and judicial controls over administrative agency activities, as well as ongoing control by Congress through funding and the continuing oversight of agencies, both in hearings and through subsequent statutory amendments.

Key Takeaway

Congress creates administrative agencies through enabling acts. In these acts, Congress must delegate authority by giving the agency some direction as to what it wants the agency to do. Agencies are usually given broad powers to investigate, set standards (promulgating regulations), and enforce those standards. Most agencies are executive branch agencies, but some are independent.

Exercises

1. Explain why Congress needs to delegate rule-making authority to a specialized agency.
2. Explain why there is any need for interference in the market by means of laws or regulations.

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11.2: Controlling Administrative Agencies

Learning Objectives

1. Understand how the president controls administrative agencies.
2. Understand how Congress controls administrative agencies.
3. Understand how the courts can control administrative agencies.

During the course of the past seventy years, a substantial debate has been conducted, often in shrill terms, about the legitimacy of administrative lawmaking. One criticism is that agencies are “captured” by the industry they are directed to regulate. Another is that they overregulate, stifling individual initiative and the ability to compete. During the 1960s and 1970s, a massive outpouring of federal law created many new agencies and greatly strengthened the hands of existing ones. In the late 1970s during the Carter administration, Congress began to deregulate American society, and deregulation increased under the Reagan administration. But the accounting frauds of WorldCom, Enron, and others led to the Sarbanes-Oxley Act of 2002, and the financial meltdown of 2008 has led to reregulation of the financial sector. It remains to be seen whether the Deepwater Horizon oil blowout of 2010 will lead to more environmental regulations or a rethinking on how to make agencies more effective regulators.

Administrative agencies are the focal point of controversy because they are policy-making bodies, incorporating facets of legislative, executive, and judicial power in a hybrid form that fits uneasily at best in the framework of American government (see Figure 5.1 "Major Administrative Agencies of the United States"). They are necessarily at the center of tugging and hauling by the legislature, the executive branch, and the judiciary, each of which has different means of exercising political control over them. In early 1990, for example, the Bush administration approved a Food and Drug Administration regulation that limited disease-prevention claims by food packagers, reversing a position by the Reagan administration in 1987 permitting such claims.

Figure 5.1 *Major Administrative Agencies of the United States*



Legislative Control

Congress can always pass a law repealing a regulation that an agency promulgates. Because this is a time-consuming process that runs counter to the reason for creating administrative bodies, it happens rarely. Another approach to controlling agencies is to reduce or threaten to reduce their appropriations. By retaining ultimate control of the purse strings, Congress can exercise considerable informal control over regulatory policy.

Executive Control

The president (or a governor, for state agencies) can exercise considerable control over agencies that are part of his cabinet departments and that are not statutorily defined as independent. Federal agencies, moreover, are subject to the fiscal scrutiny of the Office of Management and Budget (OMB), subject to the direct control of the president. Agencies are not permitted to go directly to Congress for increases in budget; these requests must be submitted through the OMB, giving the president indirect leverage over the continuation of administrators' programs and policies.

Judicial Review of Agency Actions

Administrative agencies are creatures of law and like everyone else must obey the law. The courts have jurisdiction to hear claims that the agencies have overstepped their legal authority or have acted in some unlawful manner.

Courts are unlikely to overturn administrative actions, believing in general that the agencies are better situated to judge their own jurisdiction and are experts in rulemaking for those matters delegated to them by Congress. Some agency activities are not reviewable, for a number of reasons. However, after a business (or some other interested party) has exhausted all administrative remedies, it may seek judicial review of a final agency decision. The reviewing court is often asked to strike down or modify agency actions on several possible bases (see Section 5.5.2 "Strategies for Obtaining Judicial Review" on "Strategies for Obtaining Judicial Review").

Key Takeaway

Administrative agencies are given unusual powers: to legislate, investigate, and adjudicate. But these powers are limited by executive and legislative controls and by judicial review.

Exercises

1. Find the website of the Consumer Product Safety Commission (CPSC). Identify from that site a product that has been banned by the CPSC for sale in the United States. What reasons were given for its exclusion from the US market?
2. What has Congress told the CPSC to do in its enabling act? Is this a clear enough mandate to guide the agency? What could Congress do if the CPSC does something that may be outside of the scope of its powers? What can an affected business do?

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11.3: The Administrative Procedure Act

Learning Objectives

1. Understand why the Administrative Procedure Act was needed.
2. Understand how hearings are conducted under the act.
3. Understand how the act affects rulemaking by agencies.

In 1946, Congress enacted the **Administrative Procedure Act (APA)**. This fundamental statute detailed for all federal administrative agencies how they must function when they are deciding cases or issuing regulations, the two basic tasks of administration. At the state level, the Model State Administrative Procedure Act, issued in 1946 and revised in 1961, has been adopted in twenty-eight states and the District of Columbia; three states have adopted the 1981 revision. The other states have statutes that resemble the model state act to some degree.

Trial-Type Hearings

Deciding cases is a major task of many agencies. For example, the Federal Trade Commission (FTC) is empowered to charge a company with having violated the Federal Trade Commission Act. Perhaps a seller is accused of making deceptive claims in its advertising. Proceeding in a manner similar to a court, staff counsel will prepare a case against the company, which can defend itself through its lawyers. The case is tried before an **administrative law judge** (ALJ), formerly known as an administrative hearing examiner. The change in nomenclature was made in 1972 to enhance the prestige of ALJs and more accurately reflect their duties. Although not appointed for life as federal judges are, the ALJ must be free of assignments inconsistent with the judicial function and is not subject to supervision by anyone in the agency who carries on an investigative or prosecutorial function.

The accused parties are entitled to receive notice of the issues to be raised, to present evidence, to argue, to cross-examine, and to appear with their lawyers. Ex parte (eks PAR-tay) communications—contacts between the ALJ and outsiders or one party when both parties are not present—are prohibited. However, the usual burden-of-proof standard followed in a civil proceeding in court does not apply: the ALJ is not bound to decide in favor of that party producing the more persuasive evidence. The rule in most administrative proceedings is “substantial evidence,” evidence that is not flimsy or weak, but is not necessarily overwhelming evidence, either. The ALJ in most cases will write an opinion. That opinion is not the decision of the agency, which can be made only by the commissioners or agency head. In effect, the ALJ’s opinion is appealed to the commission itself.

Certain types of agency actions that have a direct impact on individuals need not be filtered through a full-scale hearing. Safety and quality inspections (grading of food, inspection of airplanes) can be made on the spot by skilled inspectors. Certain licenses can be administered through tests without a hearing (a test for a driver’s license), and some decisions can be made by election of those affected (labor union elections).

Rulemaking

Trial-type hearings generally impose on particular parties liabilities based on past or present facts. Because these cases will serve as precedents, they are a partial guide to future conduct by others. But they do not directly apply to nonparties, who may argue in a subsequent case that their conduct does not fit within the holding announced in the case. Agencies can affect future conduct far more directly by announcing rules that apply to all who come within the agency’s jurisdiction.

The acts creating most of the major federal agencies expressly grant them authority to engage in rulemaking. This means, in essence, authority to legislate. The outpouring of federal regulations has been immense. The APA directs agencies about to engage in rulemaking to give notice in the ***Federal Register*** of their intent to do so. The *Federal Register* is published daily, Monday through Friday, in Washington, DC, and contains notice of various actions, including announcements of proposed rulemaking and regulations as adopted. The notice must specify the time, place, and nature of the rulemaking and offer a description of the proposed rule or the issues involved. Any interested person or organization is entitled to participate by submitting written “data, views or arguments.” Agencies are not legally required to air debate over proposed rules, though they often do so.

The procedure just described is known as “informal” rulemaking. A different procedure is required for “formal” rulemaking, defined as those instances in which the enabling legislation directs an agency to make rules “on the record after opportunity for an agency hearing.” When engaging in formal rulemaking, agencies must *hold* an adversary hearing.

Administrative regulations are not legally binding unless they are published. Agencies must publish in the *Federal Register* the text of final regulations, which ordinarily do not become effective until thirty days later. Every year the annual output of regulations is collected and reprinted in the ***Code of Federal Regulations* (CFR)**, a multivolume paperback series containing all federal rules and regulations keyed to the fifty titles of the US Code (the compilation of *all* federal statutes enacted by Congress and grouped according to subject).

Key Takeaway

Agencies make rules that have the same effect as laws passed by Congress and the president. But such rules (regulations) must allow for full participation by interested parties. The Administrative Procedure Act (APA) governs both rulemaking and the agency enforcement of regulations, and it provides a process for fair hearings.

Exercises

1. Go to http://www.regulations.gov/search/Regs/home.html#home. Browse the site. Find a topic that interests you, and then find a proposed regulation. Notice how comments on the proposed rule are invited.
2. Why would there be a trial by an administrative agency? Describe the process.

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11.4: Administrative Burdens on Business Operations

Learning Objectives

1. Describe the paperwork burden imposed by administrative agencies.
2. Explain why agencies have the power of investigation, and what limits there are to that power.
3. Explain the need for the Freedom of Information Act and how it works in the US legal system.

The Paperwork Burden

The administrative process is not frictionless. The interplay between government agency and private enterprise can burden business operations in a number of ways. Several of these are noted in this section.

Deciding whether and how to act are not decisions that government agencies reach out of the blue. They rely heavily on information garnered from business itself. Dozens of federal agencies require corporations to keep hundreds of types of records and to file numerous periodic reports. The Commission on Federal Paperwork, established during the Ford administration to consider ways of reducing the paperwork burden, estimated in its final report in 1977 that the total annual cost of federal paperwork amounted to $50 billion and that the 10,000 largest business enterprises spent $10 billion annually on paperwork alone. The paperwork involved in licensing a single nuclear power plant, the commission said, costs upward of $15 million.

Not surprisingly, therefore, businesses have sought ways of avoiding requests for data. Since the 1940s, the Federal Trade Commission (FTC) has collected economic data on corporate performance from individual companies for statistical purposes. As long as each company engages in a single line of business, data are comparable. When the era of conglomerates began in the 1970s, with widely divergent types of businesses brought together under the roof of a single corporate parent, the data became useless for purposes of examining the competitive behavior of different industries. So the FTC ordered dozens of large companies to break out their economic information according to each line of business that they carried on. The companies resisted, but the US Court of Appeals for the District of Columbia Circuit, where much of the litigation over federal administrative action is decided, directed the companies to comply with the commission's order, holding that the Federal Trade Commission Act clearly permits the agency to collect information for investigatory purposes.*In re FTC Line of Business Report Litigation*, 595 F.2d 685 (D.C. Cir. 1978).

In 1980, responding to cries that businesses, individuals, and state and local governments were being swamped by federal demands for paperwork, Congress enacted the Paperwork Reduction Act. It gives power to the federal Office of Management and Budget (OMB) to develop uniform policies for coordinating the gathering, storage, and transmission of all the millions of reports flowing in each year to the scores of federal departments and agencies requesting information. These reports include tax and Medicare forms, financial loan and job applications, questionnaires of all sorts, compliance reports, and tax and business records. The OMB was given the power also to determine whether new kinds of information are needed. In effect, any agency that wants to collect new information from outside must obtain the OMB's approval.

Inspections

No one likes surprise inspections. A section of the Occupational Safety and Health Act of 1970 empowers agents of the Occupational Safety and Health Administration (OSHA) to search work areas for safety hazards and for violations of OSHA regulations. The act does not specify whether inspectors are required to obtain search warrants, required under the Fourth Amendment in criminal cases. For many years, the government insisted that surprise inspections are not unreasonable and that the time required to obtain a warrant would defeat the surprise element. The Supreme Court finally ruled squarely on the issue in 1978. In *Marshall v. Barlow's, Inc.*, the court held that no less than private individuals, businesses are entitled to refuse police demands to search the premises unless a court has issued a search warrant.*Marshall v. Barlow's, Inc.*, 436 US 307 (1978).

But where a certain type of business is closely regulated, surprise inspections are the norm, and no warrant is required. For example, businesses with liquor licenses that might sell to minors are subject to both overt and covert inspections (e.g., an undercover officer may "search" a liquor store by sending an underage patron to the store). Or a junkyard that specializes in automobiles and automobile parts may also be subject to surprise inspections, on the rationale that junkyards are highly likely to

be active in the resale of stolen autos or stolen auto parts.*New York v. Burger*, 482 US 691 (1987).

It is also possible for inspections to take place without a search warrant and without the permission of the business. For example, the Environmental Protection Agency (EPA) wished to inspect parts of the Dow Chemical facility in Midland, Michigan, without the benefit of warrant. When they were refused, agents of the EPA obtained a fairly advanced aerial mapping camera and rented an airplane to fly over the Dow facility. Dow went to court for a restraining order against the EPA and a request to have the EPA turn over all photographs taken. But the Supreme Court ruled that the areas photographed were “open fields” and not subject to the protections of the Fourth Amendment.*Dow Chemical Co. v. United States Environmental Protection Agency*, 476 US 227 (1986).

Access to Business Information in Government Files

In 1966, Congress enacted the Freedom of Information Act (FOIA), opening up to the citizenry many of the files of the government. (The act was amended in 1974 and again in 1976 to overcome a tendency of many agencies to stall or refuse access to their files.) Under the FOIA, any person has a legally enforceable right of access to all government documents, with nine specific exceptions, such as classified military intelligence, medical files, and trade secrets and commercial or financial information if “obtained from a person and privileged or confidential.” Without the trade-secret and financial-information exemptions, business competitors could, merely by requesting it, obtain highly sensitive competitive information sitting in government files.

A federal agency is required under the FOIA to respond to a document request within ten days. But in practice, months or even years may pass before the government actually responds to an FOIA request. Requesters must also pay the cost of locating and copying the records. Moreover, not all documents are available for public inspection. Along with the trade-secret and financial-information exemptions, the FOIA specifically exempts the following:

- records required by executive order of the president to be kept secret in the interest of national defense or public policy
- records related solely to the internal personnel rules and practice of an agency
- records exempted from disclosure by another statute
- interagency memos or decisions reflecting the deliberative process
- personnel files and other files that if disclosed, would constitute an unwarranted invasion of personal privacy
- information compiled for law enforcement purposes
- geological information concerning wells

Note that the government may provide such information but is not required to provide such information; it retains discretion to provide information or not.

Regulated companies are often required to submit confidential information to the government. For these companies, submitting such information presents a danger under the FOIA of disclosure to competitors. To protect information from disclosure, the company is well advised to mark each document as privileged and confidential so that government officials reviewing it for a FOIA request will not automatically disclose it. Most agencies notify a company whose data they are about to disclose. But these practices are not legally required under the FOIA.

Key Takeaway

Government agencies, in order to do their jobs, collect a great deal of information from businesses. This can range from routine paperwork (often burdensome) to inspections, those with warrants and those without. Surprise inspections are allowed for closely regulated industries but are subject to Fourth Amendment requirements in general. Some information collected by agencies can be accessed using the Freedom of Information Act.

Exercises

1. Give two examples of a closely regulated industry. Explain why some warrantless searches would be allowed.
2. Find out why FOIA requests often take months or years to accomplish.

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11.5: The Scope of Judicial Review

Learning Objectives

1. Describe the “exhaustion of remedies” requirement.
2. Detail various strategies for obtaining judicial review of agency rules.
3. Explain under what circumstances it is possible to sue the government.

Neither an administrative agency’s adjudication nor its issuance of a regulation is necessarily final. Most federal agency decisions are appealable to the federal circuit courts. To get to court, the appellant must overcome numerous complex hurdles. He or she must have standing—that is, be in some sense directly affected by the decision or regulation. The case must be ripe for review; administrative remedies such as further appeal within the agency must have been exhausted.

Exhaustion of Administrative Remedies

Before you can complain to court about an agency’s action, you must first try to get the agency to reconsider its action. Generally, you must have asked for a hearing at the hearing examiner level, there must have been a decision reached that was unfavorable to you, and you must have appealed the decision to the full board. The full board must rule against you, and only then will you be heard by a court. The broadest exception to this **exhaustion of administrative remedies** requirement is if the agency had no authority to issue the rule or regulation in the first place, if exhaustion of remedies would be impractical or futile, or if great harm would happen should the rule or regulation continue to apply. Also, if the agency is not acting in good faith, the courts will hear an appeal without exhaustion.

Strategies for Obtaining Judicial Review

Once these obstacles are cleared, the court may look at one of a series of claims. The appellant might assert that the agency’s action was ultra vires (UL-truh VI-reez)—beyond the scope of its authority as set down in the statute. This attack is rarely successful. A somewhat more successful claim is that the agency did not abide by its own procedures or those imposed upon it by the Administrative Procedure Act.

In formal rulemaking, the appellant also might insist that the agency lacked substantial evidence for the determination that it made. If there is virtually no evidence to support the agency’s findings, the court may reverse. But findings of fact are not often overturned by the courts.

Likewise, there has long been a presumption that when an agency issues a regulation, it has the authority to do so: those opposing the regulation must bear a heavy burden in court to upset it. This is not a surprising rule, for otherwise courts, not administrators, would be the authors of regulations. Nevertheless, regulations cannot exceed the scope of the authority conferred by Congress on the agency. In an important 1981 case before the Supreme Court, the issue was whether the secretary of labor, acting through the Occupational Health and Safety Administration (OSHA), could lawfully issue a standard limiting exposure to cotton dust in the workplace without first undertaking a cost-benefit analysis. A dozen cotton textile manufacturers and the American Textile Manufacturers Institute, representing 175 companies, asserted that the cotton dust standard was unlawful because it did not rationally relate the benefits to be derived from the standard to the costs that the standard would impose. See Section 5.6 "Cases", *American Textile Manufacturers Institute v. Donovan*.

In summary, then, an individual or a company may (after exhaustion of administrative remedies) challenge agency action where such action is the following:

- not in accordance with the agency’s scope of authority
- not in accordance with the US Constitution or the Administrative Procedure Act
- not in accordance with the substantial evidence test
- unwarranted by the facts
- arbitrary, capricious, an abuse of discretion, or otherwise not in accord with the law

Section 706 of the Administrative Procedure Act sets out those standards. While it is difficult to show that an agency's action is arbitrary and capricious, there are cases that have so held. For example, after the Reagan administration set aside a Carter administration rule from the National Highway Traffic and Safety Administration on passive restraints in automobiles, State Farm and other insurance companies challenged the reversal as arbitrary and capricious. Examining the record, the Supreme Court found that the agency had failed to state enough reasons for its reversal and required the agency to review the record and the rule and provide adequate reasons for its reversal. State Farm and other insurance companies thus gained a legal benefit by keeping an agency rule that placed costs on automakers for increased passenger safety and potentially reducing the number of injury claims from those it had insured.*Motor Vehicle Manufacturers' Assn. v. State Farm Mutual Ins.*, 463 US 29 (1983).

Suing the Government

In the modern administrative state, the range of government activity is immense, and administrative agencies frequently get in the way of business enterprise. Often, bureaucratic involvement is wholly legitimate, compelled by law; sometimes, however, agencies or government officials may overstep their bounds, in a fit of zeal or spite. What recourse does the private individual or company have?

Mainly for historical reasons, it has always been more difficult to sue the government than to sue private individuals or corporations. For one thing, the government has long had recourse to the doctrine of sovereign immunity as a shield against lawsuits. Yet in 1976, Congress amended the Administrative Procedure Act to waive any federal claim to sovereign immunity in cases of injunctive or other nonmonetary relief. Earlier, in 1946, in the Federal Tort Claims Act, Congress had waived sovereign immunity of the federal government for most tort claims for money damages, although the act contains several exceptions for specific agencies (e.g., one cannot sue for injuries resulting from fiscal operations of the Treasury Department or for injuries stemming from activities of the military in wartime). The act also contains a major exception for claims "based upon [an official's] exercise or performance or the failure to exercise or perform a discretionary function or duty." This exception prevents suits against parole boards for paroling dangerous criminals who then kill or maim in the course of another crime and suits against officials whose decision to ship explosive materials by public carrier leads to mass deaths and injuries following an explosion en route.*Dalehite v. United States*, 346 US 15 (1953).

In recent years, the Supreme Court has been stripping away the traditional immunity enjoyed by many government officials against personal suits. Some government employees—judges, prosecutors, legislators, and the president, for example—have absolute immunity against suit for official actions. But many public administrators and government employees have at best a qualified immunity. Under a provision of the Civil Rights Act of 1871 (so-called Section 1983 actions), *state* officials can be sued in federal court for money damages whenever "under color of any state law" they deprive anyone of his rights under the Constitution or federal law. In *Bivens v. Six Unknown Federal Narcotics Agents*, the Supreme Court held that *federal* agents may be sued for violating the plaintiff's Fourth Amendment rights against an unlawful search of his home.*Bivens v. Six Unknown Federal Narcotics Agents*, 403 US 388 (1971). Subsequent cases have followed this logic to permit suits for violations of other constitutional provisions. This area of the law is in a state of flux, and it is likely to continue to evolve.

Sometimes damage is done to an individual or business because the government has given out erroneous information. For example, suppose that Charles, a bewildered, disabled navy employee, is receiving a federal disability annuity. Under the regulations, he would lose his pension if he took a job that paid him in each of two succeeding years more than 80 percent of what he earned in his old navy job. A few years later, Congress changed the law, making him ineligible if he earned more than 80 percent in anyone year. For many years, Charles earned considerably less than the ceiling amount. But then one year he got the opportunity to make some extra money. Not wishing to lose his pension, he called an employee relations specialist in the US Navy and asked how much he could earn and still keep his pension. The specialist gave him erroneous information over the telephone and then sent him an out-of-date form that said Charles could safely take on the extra work. Unfortunately, as it turned out, Charles did exceed the salary limit, and so the government cut off his pension during the time he earned too much. Charles sues to recover his lost pension. He argues that he relied to his detriment on false information supplied by the navy and that in fairness the government should be estopped from denying his claim.

Unfortunately for Charles, he will lose his case. In *Office of Personnel Management v. Richmond*, the Supreme Court reasoned that it would be unconstitutional to permit recovery.*Office of Personnel Management v. Richmond*, 110 S. Ct. 2465 (1990). The appropriations clause of Article I says that federal money can be paid out only through an appropriation made by law. The law prevented this particular payment to be made. If the court were to make an exception, it would permit executive officials in effect to make binding payments, even though unauthorized, simply by misrepresenting the facts. The harsh reality, therefore, is that mistakes of the government are generally held against the individual, not the government, unless the law specifically provides for recompense (as, for example, in the Federal Tort Claims Act just discussed).

Key Takeaway

After exhausting administrative remedies, there are numerous grounds for seeking judicial review of an agency's order or of a final rule. While courts defer to agencies to some degree, an agency must follow its own rules, comply with the Administrative Procedure Act, act within the scope of its delegated authority, avoid acting in an arbitrary manner, and make final rules that are supported by substantial evidence.

Exercises

1. Why would US courts require that someone seeking judicial review of an agency order first exhaust administrative remedies?
2. On the Internet, find a case where someone has successfully sued the US government under the Federal Tort Claims Act. What kind of case was it? Did the government argue sovereign immunity? Does sovereign immunity even make sense to you?

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11.6: Cases

Marshall v. Barlow's, Inc.

Marshall v. Barlow's, Inc.

436 U.S. 307 (U.S. Supreme Court 1978)

MR. JUSTICE WHITE delivered the opinion of the Court.

Section 8(a) of the Occupational Safety and Health Act of 1970 (OSHA or Act) empowers agents of the Secretary of Labor (Secretary) to search the work area of any employment facility within the Act's jurisdiction. The purpose of the search is to inspect for safety hazards and violations of OSHA regulations. No search warrant or other process is expressly required under the Act.

On the morning of September 11, 1975, an OSHA inspector entered the customer service area of Barlow's, Inc., an electrical and plumbing installation business located in Pocatello, Idaho. The president and general manager, Ferrol G. "Bill" Barlow, was on hand; and the OSHA inspector, after showing his credentials, informed Mr. Barlow that he wished to conduct a search of the working areas of the business. Mr. Barlow inquired whether any complaint had been received about his company. The inspector answered no, but that Barlow's, Inc., had simply turned up in the agency's selection process. The inspector again asked to enter the nonpublic area of the business; Mr. Barlow's response was to inquire whether the inspector had a search warrant.

The inspector had none. Thereupon, Mr. Barlow refused the inspector admission to the employee area of his business. He said he was relying on his rights as guaranteed by the Fourth Amendment of the United States Constitution.

Three months later, the Secretary petitioned the United States District Court for the District of Idaho to issue an order compelling Mr. Barlow to admit the inspector. The requested order was issued on December 30, 1975, and was presented to Mr. Barlow on January 5, 1976. Mr. Barlow again refused admission, and he sought his own injunctive relief against the warrantless searches assertedly permitted by OSHA....The Warrant Clause of the Fourth Amendment protects commercial buildings as well as private homes. To hold otherwise would belie the origin of that Amendment, and the American colonial experience.

An important forerunner of the first 10 Amendments to the United States Constitution, the Virginia Bill of Rights, specifically opposed "general warrants, whereby an officer or messenger may be commanded to search suspected places without evidence of a fact committed." The general warrant was a recurring point of contention in the Colonies immediately preceding the Revolution. The particular offensiveness it engendered was acutely felt by the merchants and businessmen whose premises and products were inspected for compliance with the several parliamentary revenue measures that most irritated the colonists....

* * *

This Court has already held that warrantless searches are generally unreasonable, and that this rule applies to commercial premises as well as homes. In *Camara v. Municipal Court*, we held:

[E]xcept in certain carefully defined classes of cases, a search of private property without proper consent is 'unreasonable' unless it has been authorized by a valid search warrant.

On the same day, we also ruled: As we explained in *Camara*, a search of private houses is presumptively unreasonable if conducted without a warrant. The businessman, like the occupant of a residence, has a constitutional right to go about his business free from unreasonable official entries upon his private commercial property. The businessman, too, has that right placed in jeopardy if the decision to enter and inspect for violation of regulatory laws can be made and enforced by the inspector in the field without official authority evidenced by a warrant. These same cases also held that the Fourth Amendment prohibition against unreasonable searches protects against warrantless intrusions during civil as well as criminal investigations. The reason is found in the "basic purpose of this Amendment...[which] is to safeguard the privacy and security of individuals against arbitrary invasions by governmental officials." If the government intrudes on a person's property, the privacy interest suffers whether the government's motivation is to investigate violations of criminal laws or breaches of other statutory or regulatory standards....

[A]n exception from the search warrant requirement has been recognized for "pervasively regulated business[es]," *United States v. Biswell*, 406 U.S. 311, 316 (1972), and for "closely regulated" industries "long subject to close supervision and inspection,"

Colonnade Catering Corp. v. United States, 397 U.S. 72, 74, 77 (1970). These cases are indeed exceptions, but they represent responses to relatively unique circumstances. Certain industries have such a history of government oversight that no reasonable expectation of privacy could exist for a proprietor over the stock of such an enterprise. Liquor (*Colonnade*) and firearms (*Biswell*) are industries of this type when an entrepreneur embarks upon such a business, he has voluntarily chosen to subject himself to a full arsenal of governmental regulation.

* * *

The clear import of our cases is that the closely regulated industry of the type involved in *Colonnade* and *Biswell* is the exception. The Secretary would make it the rule. Invoking the Walsh-Healey Act of 1936, 41 U.S.C. § 35 et *seq.*, the Secretary attempts to support a conclusion that all businesses involved in interstate commerce have long been subjected to close supervision of employee safety and health conditions. But...it is quite unconvincing to argue that the imposition of minimum wages and maximum hours on employers who contracted with the Government under the Walsh-Healey Act prepared the entirety of American interstate commerce for regulation of working conditions to the minutest detail. Nor can any but the most fictional sense of voluntary consent to later searches be found in the single fact that one conducts a business affecting interstate commerce. Under current practice and law, few businesses can be conducted without having some effect on interstate commerce.

* * *

The critical fact in this case is that entry over Mr. Barlow's objection is being sought by a Government agent. Employees are not being prohibited from reporting OSHA violations. What they observe in their daily functions is undoubtedly beyond the employer's reasonable expectation of privacy. The Government inspector, however, is not an employee. Without a warrant he stands in no better position than a member of the public. What is observable by the public is observable, without a warrant, by the Government inspector as well. The owner of a business has not, by the necessary utilization of employees in his operation, thrown open the areas where employees alone are permitted to the warrantless scrutiny of Government agents. That an employee is free to report, and the Government is free to use, any evidence of noncompliance with OSHA that the employee observes furnishes no justification for federal agents to enter a place of business from which the public is restricted and to conduct their own warrantless search.

* * *

[The District Court judgment is affirmed.]

CASE QUESTIONS

1. State, as briefly and clearly as possible, the argument that Barlow's is making in this case.
2. Why would some industries or businesses be "closely regulated"? What are some of those businesses?
3. The Fourth Amendment speaks of "people" being secure in their "persons, houses, papers, and effects." Why would the Fourth Amendment apply to a business, which is not in a "house"?
4. If the Fourth Amendment does not distinguish between closely regulated industries and those that are not, why does the court do so?

American Textile Manufacturers Institute v. Donovan

American Textile Manufacturers Institute v. Donovan

452 U.S. 490 (1981)

JUSTICE BRENNAN delivered the opinion of the Court.

Congress enacted the Occupational Safety and Health Act of 1970 (Act) "to assure so far as possible every working man and woman in the Nation safe and healthful working conditions...."The Act authorizes the Secretary of Labor to establish, after notice and opportunity to comment, mandatory nationwide standards governing health and safety in the workplace. In 1978, the Secretary, acting through the Occupational Safety and Health Administration (OSHA), promulgated a standard limiting occupational exposure to cotton dust, an airborne particle byproduct of the preparation and manufacture of cotton products, exposure to which produces a "constellation of respiratory effects" known as "byssinosis." This disease was one of the expressly recognized health hazards that led to passage of the Act.

Petitioners in these consolidated cases representing the interests of the cotton industry, challenged the validity of the "Cotton Dust Standard" in the Court of Appeals for the District of Columbia Circuit pursuant to § 6 (f) of the Act, 29 U.S.C. § 655 (f). They contend in this Court, as they did below, that the Act requires OSHA to demonstrate that its Standard reflects a reasonable relationship between the costs and benefits associated with the Standard. Respondents, the Secretary of Labor and two labor organizations, counter that Congress balanced the costs and benefits in the Act itself, and that the Act should therefore be construed not to require OSHA to do so. They interpret the Act as mandating that OSHA enact the most protective standard possible to eliminate a significant risk of material health impairment, subject to the constraints of economic and technological feasibility.

The Court of Appeals held that the Act did not require OSHA to compare costs and benefits.

We granted certiorari, 449 U.S. 817 (1980), to resolve this important question, which was presented but not decided in last Term's *Industrial Union Dept. v. American Petroleum Institute*, 448 U.S. 607 (1980), and to decide other issues related to the Cotton Dust Standard.

* * *

Not until the early 1960's was byssinosis recognized in the United States as a distinct occupational hazard associated with cotton mills. In 1966, the American Conference of Governmental Industrial Hygienists (ACGIH), a private organization, recommended that exposure to total cotton dust be limited to a "threshold limit value" of 1,000 micrograms per cubic meter of air (1,000 g/m^3.) averaged over an 8-hour workday. See 43 Fed. Reg. 27351, col. 1 (1978). The United States Government first regulated exposure to cotton dust in 1968, when the Secretary of Labor, pursuant to the Walsh-Healey Act, 41 U.S.C. 35 (e), promulgated airborne contaminant threshold limit values, applicable to public contractors, that included the 1,000 g/m^3 limit for total cotton dust. 34 Fed. Reg. 7953 (1969). Following passage of the Act in 1970, the 1,000 g/m^3. standard was adopted as an "established Federal standard" under 6 (a) of the Act, 84 Stat. 1593, 29 U.S.C. 655 (a), a provision designed to guarantee immediate protection of workers for the period between enactment of the statute and promulgation of permanent standards.

That same year, the Director of the National Institute for Occupational Safety and Health (NIOSH), pursuant to the Act, 29 U.S.C. §§ 669(a)(3), 671 (d)(2), submitted to the Secretary of Labor a recommendation for a cotton dust standard with a permissible exposure limit (PEL) that "should be set at the lowest level feasible, but in no case at an environmental concentration as high as 0.2 mg lint-free cotton dust/cu m," or 200 g/m^3. of lint-free respirable dust. Several months later, OSHA published an Advance Notice of Proposed Rulemaking, 39 Fed.Reg. 44769 (1974), requesting comments from interested parties on the NIOSH recommendation and other related matters. Soon thereafter, the Textile Worker's Union of America, joined by the North Carolina Public Interest Research Group, petitioned the Secretary, urging a more stringent PEL of 100 g/m^3.

On December 28, 1976, OSHA published a proposal to replace the existing federal standard on cotton dust with a new permanent standard, pursuant to § 6(b)(5) of the Act, 29 U.S.C. § 655(b)(5). 41 Fed.Reg. 56498. The proposed standard contained a PEL of 200 g/m^3 of vertical elutriated lint-free respirable cotton dust for all segments of the cotton industry. *Ibid.* It also suggested an implementation strategy for achieving the PEL that relied on respirators for the short term and engineering controls for the long-term. OSHA invited interested parties to submit written comments within a 90-day period.

* * *

The starting point of our analysis is the language of the statute itself. Section 6(b)(5) of the Act, 29 U.S.C. § 655(b)(5) (emphasis added), provides:

The Secretary, in promulgating standards dealing with toxic materials or harmful physical agents under this subsection, shall set the standard which most adequately assures, **to the extent feasible**, on the basis of the best available evidence, that no employee will suffer material impairment of health or functional capacity even if such employee has regular exposure to the hazard dealt with by such standard for the period of his working life. Although their interpretations differ, all parties agree that the phrase "to the extent feasible" contains the critical language in § 6(b)(5) for purposes of these cases.

The plain meaning of the word "feasible" supports respondents' interpretation of the statute. According to Webster's Third New International Dictionary of the English Language 831 (1976), "feasible" means "capable of being done, executed, or effected." In accord, the Oxford English Dictionary 116 (1933) ("Capable of being done, accomplished or carried out"); Funk & Wagnalls New "Standard" Dictionary of the English Language 903 (1957) ("That may be done, performed or effected"). Thus, § 6(b)(5) directs the Secretary to issue the standard that "most adequately assures...that no employee will suffer material impairment of health," limited only by the extent to which this is "capable of being done." In effect then, as the Court of Appeals held, Congress itself

defined the basic relationship between costs and benefits, by placing the "benefit" of worker health above all other considerations save those making attainment of this "benefit" unachievable. Any standard based on a balancing of costs and benefits by the Secretary that strikes a different balance than that struck by Congress would be inconsistent with the command set forth in § 6(b)(5). Thus, cost-benefit analysis by OSHA is not required by the statute because feasibility analysis is.

When Congress has intended that an agency engage in cost-benefit analysis, it has clearly indicated such intent on the face of the statute. One early example is the Flood Control Act of 1936, 33 U.S.C. § 701:

[T]he Federal Government should improve or participate in the improvement of navigable waters or their tributaries, including watersheds thereof, for flood control purposes if the **benefits to whomsoever they may accrue are in excess of the estimated costs**, and if the lives and social security of people are otherwise adversely affected. (emphasis added)

A more recent example is the Outer Continental Shelf Lands Act Amendments of 1978, providing that offshore drilling operations shall use the best available and safest technologies which the Secretary determines to be economically *feasible*, wherever failure of equipment would have a significant effect on safety, health, or the environment, except where the Secretary determines that the *incremental benefits are clearly insufficient to justify the incremental costs of using such technologies*.

These and other statutes demonstrate that Congress uses specific language when intending that an agency engage in cost-benefit analysis. Certainly in light of its ordinary meaning, the word "feasible" cannot be construed to articulate such congressional intent. We therefore reject the argument that Congress required cost-benefit analysis in § 6(b)(5).

CASE QUESTIONS

1. What is byssinosis? Why should byssinosis be anything that the textile companies are responsible for, ethically or legally? If it is well-known that textile workers get cotton dust in their systems and develop brown lung, don't they nevertheless choose to work there and assume the risk of all injuries?
2. By imposing costs on the textile industry, what will be the net effect on US textile manufacturing jobs?
3. How is byssinosis a "negative externality" that is not paid for by either the manufacturer or the consumer of textile products? How should the market, to be fair and efficient, adjust for these negative externalities *other* than by setting a reasonable standard that shares the burden between manufacturers and their employees? Should *all* the burden be on the manufacturer?

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11.7: Summary and Exercises

Summary

Administrative rules and regulations constitute the largest body of laws that directly affect business. These regulations are issued by dozens of federal and state agencies that regulate virtually every aspect of modern business life, including the natural environment, corporate finance, transportation, telecommunications, energy, labor relations, and trade practices. The administrative agencies derive their power to promulgate regulations from statutes passed by Congress or state legislatures.

The agencies have a variety of powers. They can license companies to carry on certain activities or prohibit them from doing so, lay down codes of conduct, set rates that companies may charge for their services, and supervise various aspects of business.

Exercises

1. The Equal Employment Opportunity Commission seeks data about the racial composition of Terrific Textiles' labor force. Terrific refuses on the grounds that inadvertent disclosure of the numbers might cause certain "elements" to picket its factories. The EEOC takes Terrific to court to get the data. What is the result?
2. In order to police the profession, the state legislature has just passed a law permitting the State Plumbers' Association the power to hold hearings to determine whether a particular plumber has violated the plumbing code of ethics, written by the association. Sam, a plumber, objects to the convening of a hearing when he is accused by Roger, a fellow plumber, of acting unethically by soliciting business from Roger's customers. Sam goes to court, seeking to enjoin the association's disciplinary committee from holding the hearing. What is the result? How would you argue Sam's case? The association's case?
3. Assume that the new president of the United States was elected overwhelmingly by pledging in his campaign to "do away with bureaucrats who interfere in your lives." The day he takes the oath of office he determines to carry out his pledge. Discuss which of the following courses he may lawfully follow: (a) Fire all incumbent commissioners of federal agencies in order to install new appointees. (b) Demand that all pending regulations being considered by federal agencies be submitted to the White House for review and redrafting, if necessary. (c) Interview potential nominees for agency positions to determine whether their regulatory philosophy is consistent with his.
4. Dewey owned a mine in Wisconsin. He refused to allow Department of Labor agents into the mine to conduct warrantless searches to determine whether previously found safety violations had been corrected. The Federal Mine Safety and Health Amendments Act of 1977 authorizes four warrantless inspections per year. Is the provision for warrantless inspections by this agency constitutional?*Donovan v. Dewey*, 452 US 594 (1981).
5. In determining the licensing requirements for nuclear reactors, the Nuclear Regulatory Commission (NRC) adopted a zero-release assumption: that the permanent storage of certain nuclear waste would have no significant environmental impact and that potential storage leakages should not be a factor discussed in the appropriate environmental impact statement (EIS) required before permitting construction of a nuclear power plant. This assumption is based on the NRC's belief that technology would be developed to isolate the wastes from the environment, and it was clear from the record that the NRC had "digested a massive material and disclosed all substantial risks" and had considered that the zero-release assumption was uncertain. There was a remote possibility of contamination by water leakage into the storage facility. An environmental NGO sued, asserting that the NRC had violated the regulations governing the EIS by arbitrarily and capriciously ignoring the potential contamination. The court of appeals agreed, and the power plant appealed. Had the NRC acted arbitrarily and capriciously?*Baltimore Gas and Electric Co. v. Natural Resources Defense Council Inc.*, 462 US 87 (1983).

SELF-TEST QUESTIONS

1. Most federal administrative agencies are created by
    1. an executive order by the president
    2. a Supreme Court decision
    3. the passage of enabling legislation by Congress, signed by the president
    4. a and c
2. The Federal Trade Commission, like most administrative agencies of the federal government, is part of
    1. the executive branch of government
    2. the legislative branch of government

3. the judicial branch of government
4. the administrative branch of government

3. In the Clean Water Act, Congress sets broad guidelines, but it is the Environmental Protection Agency that proposes rules to regulate industrial discharges. Where do proposed rules originally appear?
    1. in the Congressional record
    2. in the *Federal Register*
    3. in the *Code of Federal Regulations*
    4. in the United States code service
4. The legal basis for all administrative law, including regulations of the Federal Trade Commission, is found in
    1. the Administrative Procedure Act
    2. the US Constitution
    3. the commerce clause
    4. none of the above
5. The Federal Trade Commission, like other administrative agencies, has the power to
    1. issue proposed rules
    2. undertake investigations of firms that may have violated FTC regulations
    3. prosecute firms that have violated FTC regulations
    4. none of the above
    5. all of the above

SELF-TEST AnswerS

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

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12: INTELLECTUAL PROPERTY

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12.2: Patents
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12.1: Chapter Introduction

Learning Objectives

1. The principal kinds of intellectual property
2. The difference between patents and trade secrets, and why a company might choose to rely on trade secrets rather than obtain a patent
3. What copyrights are, how to obtain them, and how they differ from trademarks
4. Why some “marks” may not be eligible for trademark protection, and how to obtain trademark protection for those that are

Few businesses of any size could operate 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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12.2: Patents

Learning Objectives

1. Explain why Congress would grant exclusive monopolies (patents) for certain periods of time.
2. Describe what kinds of things may be patentable and what kinds of things may not be patentable.
3. Explain the procedures for obtaining a patent, and how patent rights may be an issue where the invention is created by an employee.
4. 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*,*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. DiehrDiamond 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.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*,*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 (172 countries as of 2011). 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*,*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*,*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 18.1.2 "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. 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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12.3: Trade Secrets

Learning Objectives

1. Describe the difference between trade secrets and patents, and explain why a firm might prefer keeping a trade secret rather than obtaining a patent.
2. 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 second sectionEconomic Espionage Act, 18 United States Code, Section 1832 (1996). criminalizes the misappropriation of trade secrets related to or included in a product that is produced for or placed in interstate (including international) commerce, with the knowledge or intent that the misappropriation will injure the owner of the trade secret. Penalties for violation are imprisonment for up to ten years for individuals (no fines) and fines of up to US$5 million for organizations.

In addition to these specific penalties, the fourth section of the EEAEconomic Espionage Act, 18 United States Code, Section 1834 (1996). also requires criminal forfeiture of (1) any proceeds of the crime and property derived from proceeds of the crime and (2) any property used, or intended to be used, in commission of the crime.

The EEA authorizes civil proceedings by the Department of Justice to enjoin violations of the act but does not create a private cause of action. This means that anyone believing they have been victimized must go through the US attorney general in order to obtain an injunction.

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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12.4: Copyright

Learning Objectives

1. Describe and explain copyrights, how to obtain one, and how they differ from trademarks.
2. 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). Now the courts are wrestling with the more difficult question of the scope of protection: what constitutes an "idea" and what constitutes its mere "expression" in a program.

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 Time*s, 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.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 Time*s and is paid for doing so. Suppose he wants to leave the employ of the *Time*s and be a freelance writer. Can he compile his best articles into a book, *Changing Time*s *in China*, and publish it without the *New York Time*s’s permission? Does it matter that he uses the word *Time*s 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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12.5: Trademarks

Learning Objectives

1. Understand what a trademark is and why it deserves protection.
2. Know why some “marks” may not be eligible for trademark protection, and how to obtain trademark protection for those that are.
3. 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 shape of a whiskey bottle (Haig & Haig’s Pinch 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. Until 1990, the office received about 77,000 applications each year. With the change in procedure, some experts predicted that applications would rise by 30 percent.

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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12.6: Cases

Fair Use in Copyright

Elvis Presley Enterprises et al. v. Passport Video et al.

349 F.3d 622 (9th Circuit Court of Appeals, 2003)

TALLMAN, CIRCUIT JUDGE:

Plaintiffs are a group of companies and individuals holding copyrights in various materials relating to Elvis Presley. For example, plaintiff SOFA Entertainment, Inc., is the registered owner of several Elvis appearances on *The Ed Sullivan Show*. Plaintiff Promenade Trust owns the copyright to two television specials featuring Elvis: *The Elvis 1968 Comeback Special* and *Elvis Aloha from Hawaii*....Many Plaintiffs are in the business of licensing their copyrights. For example, SOFA Entertainment charges $10,000 per minute for use of Elvis' appearances on *The Ed Sullivan Show*.

Passport Entertainment and its related entities (collectively "Passport") produced and sold *The Definitive Elvis*, a 16-hour video documentary about the life of Elvis Presley. *The Definitive Elvis* sold for $99 at retail. Plaintiffs allege that thousands of copies were sent to retail outlets and other distributors. On its box, *The Definitive Elvis* describes itself as an all-encompassing, in-depth look at the life and career of a man whose popularity is unrivaled in the history of show business and who continues to attract millions of new fans each year....

The Definitive Elvis uses Plaintiffs' copyrighted materials in a variety of ways. With the video footage, the documentary often uses shots of Elvis appearing on television while a narrator or interviewee talks over the film. These clips range from only a few seconds in length to portions running as long as 30 seconds. In some instances, the clips are the subject of audio commentary, while in other instances they would more properly be characterized as video "filler" because the commentator is discussing a subject different from or more general than Elvis' performance on a particular television show. But also significant is the frequency with which the copyrighted video footage is used. *The Definitive Elvis* employs these clips, in many instances, repeatedly. In total, at least 5% to 10% of *The Definitive Elvis* uses Plaintiffs' copyrighted materials.

Use of the video footage, however, is not limited to brief clips....Thirty-five percent of his appearances on *The Ed Sullivan Show* is replayed, as well as three minutes from *The 1968 Comeback Special*.

* * *

Plaintiffs sued Passport for copyright infringement....Passport, however, asserts that its use of the copyrighted materials was "fair use" under 17 U.S.C. § 107. Plaintiffs moved for a preliminary injunction, which was granted by the district court after a hearing. The district court found that Passport's use of Plaintiffs' copyrighted materials was likely not fair use. The court enjoined Passport from selling or distributing *The Definitive Elvis*. Passport timely appeals.

* * *

We first address the purpose and character of Passport's use of Plaintiffs' copyrighted materials. Although not controlling, the fact that a new use is commercial as opposed to non-profit weighs against a finding of fair use. *Harper & Row Publishers, Inc. v. Nation Enters.*, 471 U.S. 539, 562, 85 L. Ed. 2d 588, 105 S.Ct. 2218 (1985). And the degree to which the new user exploits the copyright for commercial gain—as opposed to incidental use as part of a commercial enterprise—affects the weight we afford commercial nature as a factor. More importantly for the first fair-use factor, however, is the "transformative" nature of the new work. Specifically, we ask "whether the new work...merely supersedes the objects of the original creation, or instead adds something new, with a further purpose or different character, altering the first with new expression, meaning, or message...." The more transformative a new work, the less significant other inquiries, such as commercialism, become.

* * *

The district court below found that the purpose and character of *The Definitive Elvis* will likely weigh against a finding of fair use. We cannot say, based on this record, that the district court abused its discretion.

First, Passport's use, while a biography, is clearly commercial in nature. But more significantly, Passport seeks to profit directly from the copyrights it uses without a license. One of the most salient selling points on the box of *The Definitive Elvis* is that "Every Film and Television Appearance is represented." Passport is not advertising a scholarly critique or historical analysis, but instead seeks to profit at least in part from the inherent entertainment value of Elvis' appearances on such shows as *The Steve Allen Show*, *The Ed Sullivan Show*, and *The 1968 Comeback Special*. Passport's claim that this is scholarly research containing biographical comments on the life of Elvis is not dispositive of the fair use inquiry.

Second, Passport's use of Plaintiffs' copyrights is not consistently transformative. True, Passport's use of many of the television clips is transformative because the clips play for only a few seconds and are used for reference purposes while a narrator talks over them or interviewees explain their context in Elvis' career. But voice-overs do not necessarily transform a work....

It would be impossible to produce a biography of Elvis without showing some of his most famous television appearances for reference purposes. But some of the clips are played without much interruption, if any. The purpose of showing these clips likely goes beyond merely making a reference for a biography, but instead serves the same intrinsic entertainment value that is protected by Plaintiffs' copyrights.

* * *

The third factor is the amount and substantiality of the portion used in relation to the copyrighted work as a whole. This factor evaluates both the quantity of the work taken and the quality and importance of the portion taken. Regarding the quantity, copying "may not be excused merely because it is insubstantial with respect to the *infringing* work." *Harper & Row*, 471 U.S. at 565 (emphasis in original). But if the amount used is substantial with respect to the infringing work, it is evidence of the value of the copy-righted work.

Passport's use of clips from television appearances, although in most cases of short duration, were repeated numerous times throughout the tapes. While using a small number of clips to reference an event for biographical purposes seems fair, using a clip over and over will likely no longer serve a biographical purpose. Additionally, some of the clips were not short in length. Passport's use of Elvis' appearance on *The Steve Allen Show* plays for over a minute and many more clips play for more than just a few seconds.

Additionally, although the clips are relatively short when compared to the entire shows that are copyrighted, they are in many instances the heart of the work. What makes these copyrighted works valuable is Elvis' appearance on the shows, in many cases singing the most familiar passages of his most popular songs. Plaintiffs are in the business of licensing these copyrights. Taking key portions extracts the most valuable part of Plaintiffs' copyrighted works. With respect to the photographs, the entire picture is often used. The music, admittedly, is usually played only for a few seconds.

* * *

The last, and "undoubtedly the single most important" of all the factors, is the effect the use will have on the potential market for and value of the copyrighted works. *Harper & Row*, 471 U.S. at 566. We must "consider not only the extent of market harm caused by the particular actions of the alleged infringer, but also whether unrestricted and widespread conduct of the sort engaged in by the defendant...would result in a substantially adverse impact on the potential market for the original." *Campbell*, 510 U.S. at 590. The more transformative the new work, the less likely the new work's use of copyrighted materials will affect the market for the materials. Finally, if the purpose of the new work is commercial in nature, "the likelihood [of market harm] may be presumed." *A&M Records*, 239 F.3d at 1016 (quoting *Sony*, 464 U.S. at 451).

The district court found that Passport's use of Plaintiffs' copyrighted materials likely does affect the market for those materials. This conclusion was not clearly erroneous.

First, Passport's use is commercial in nature, and thus we can assume market harm. Second, Passport has expressly advertised that *The Definitive Elvis* contains the television appearances for which Plaintiffs normally charge a licensing fee. If this type of use became wide-spread, it would likely undermine the market for selling Plaintiffs' copyrighted material. This conclusion, however, does not apply to the music and still photographs. It seems unlikely that someone in the market for these materials would purchase *The Definitive Elvis* instead of a properly licensed product. Third, Passport's use of the television appearances was, in some instances, not transformative, and therefore these uses are likely to affect the market because they serve the same purpose as Plaintiffs' original works.

* * *

We emphasize that our holding today is not intended to express how we would rule were we examining the case *ab initio* as district judges. Instead, we confine our review to whether the district court abused its discretion when it weighed the four statutory fair-use factors together and determined that Plaintiffs would likely succeed on the merits. Although we might view this case as closer than the district court saw it, we hold there was no abuse of discretion in the court's decision to grant Plaintiffs' requested relief.

AFFIRMED.

CASE QUESTIONS

1. How would you weigh the four factors in this case? If the trial court had found fair use, would the appeals court have overturned its ruling?
2. Why do you think that the fourth factor is especially important?
3. What is the significance of the discussion on "transformative" aspects of the defendant's product?

Trademark Infringement and Dilution

Playboy Enterprises v. Welles

279 F.3d 796 (9th Circuit Court of Appeals, 2001)

T. G. NELSON, Circuit Judge:

Terri Welles was on the cover of Playboy in 1981 and was chosen to be the Playboy Playmate of the Year for 1981. Her use of the title "Playboy Playmate of the Year 1981," and her use of other trademarked terms on her website are at issue in this suit. During the relevant time period, Welles' website offered information about and free photos of Welles, advertised photos for sale, advertised memberships in her photo club, and promoted her services as a spokesperson. A biographical section described Welles' selection as Playmate of the Year in 1981 and her years modeling for PEI. The site included a disclaimer that read as follows: "This site is neither endorsed, nor sponsored, nor affiliated with Playboy Enterprises, Inc. PLAYBOY tm PLAYMATE OF THE YEAR tm AND PLAYMATE OF THE MONTH tm are registered trademarks of Playboy Enterprises, Inc."

Wells used (1) the terms "Playboy "and "Playmate" in the metatags of the website; (2) the phrase "Playmate of the Year 1981" on the masthead of the website; (3) the phrases "Playboy Playmate of the Year 1981" and "Playmate of the Year 1981" on various banner ads, which may be transferred to other websites; and (4) the repeated use of the abbreviation "PMOY '81" as the watermark on the pages of the website. PEI claimed that these uses of its marks constituted trademark infringement, dilution, false designation of origin, and unfair competition. The district court granted defendants' motion for summary judgment. PEI appeals the grant of summary judgment on its infringement and dilution claims. We affirm in part and reverse in part.

A. Trademark Infringement

Except for the use of PEI's protected terms in the wallpaper of Welles' website, we conclude that Welles' uses of PEI's trademarks are permissible, nominative uses. They imply no current sponsorship or endorsement by PEI. Instead, they serve to identify Welles as a past PEI "Playmate of the Year."

We articulated the test for a permissible, nominative use in *New Kids On The Block v. New America Publishing, Inc*. The band, New Kids On The Block, claimed trademark infringement arising from the use of their trademarked name by several newspapers. The newspapers had conducted polls asking which member of the band New Kids On The Block was the best and most popular. The papers' use of the trademarked term did not fall within the traditional fair use doctrine. Unlike a traditional fair use scenario, the defendant newspaper was using the trademarked term to describe not its own product, but the plaintiff's. Thus, the factors used to evaluate fair use were inapplicable. The use was nonetheless permissible, we concluded, based on its nominative nature.

We adopted the following test for nominative use:

First, the product or service in question must be one not readily identifiable without use of the trademark; second, only so much of the mark or marks may be used as is reasonably necessary to identify the product or service; and third, the user must do nothing that would, in conjunction with the mark, suggest sponsorship or endorsement by the trademark holder.

We group the uses of PEI's trademarked terms into three for the purpose of applying the test for nominative use.

1. Headlines and banner advertisements.

. . .

The district court properly identified Welles' situation as one which must... be excepted. No descriptive substitute exists for PEI's trademarks in this context....Just as the newspapers in *New Kids* could only identify the band clearly by using its trademarked name, so can Welles only identify herself clearly by using PEI's trademarked title.

The second part of the nominative use test requires that "only so much of the mark or marks may be used as is reasonably necessary to identify the product or service[.]" *New Kids* provided the following examples to explain this element: "[A] soft drink competitor would be entitled to compare its product to Coca-Cola or Coke, but would not be entitled to use Coca-Cola's distinctive lettering." Similarly, in a past case, an auto shop was allowed to use the trademarked term "Volkswagen" on a sign describing the cars it repaired, in part because the shop "did not use Volkswagen's distinctive lettering style or color scheme, nor did he display the encircled 'VW' emblem." Welles' banner advertisements and headlines satisfy this element because they use only the trademarked words, not the font or symbols associated with the trademarks.

The third element requires that the user do "nothing that would, in conjunction with the mark, suggest sponsorship or endorsement by the trademark holder." As to this element, we conclude that aside from the wallpaper, which we address separately, Welles does nothing in conjunction with her use of the marks to suggest sponsorship or endorsement by PEI. The marks are clearly used to describe the title she received from PEI in 1981, a title that helps describe who she is. It would be unreasonable to assume that the Chicago Bulls sponsored a website of Michael Jordan's simply because his name appeared with the appellation "former Chicago Bull." Similarly, in this case, it would be unreasonable to assume that PEI currently sponsors or endorses someone who describes herself as a "Playboy Playmate of the Year in 1981." The designation of the year, in our case, serves the same function as the "former" in our example. It shows that any sponsorship or endorsement occurred in the past.

For the foregoing reasons, we conclude that Welles' use of PEI's marks in her headlines and banner advertisements is a nominative use excepted from the law of trademark infringement.

2. Metatags

Welles includes the terms "playboy" and "playmate" in her metatags. Metatags describe the contents of a website using keywords. Some search engines search metatags to identify websites relevant to a search. Thus, when an internet searcher enters "playboy" or "playmate" into a search engine that uses metatags, the results will include Welles' site. Because Welles' metatags do not repeat the terms extensively, her site will not be at the top of the list of search results. Applying the three-factor test for nominative use, we conclude that the use of the trademarked terms in Welles' metatags is nominative.

As we discussed above with regard to the headlines and banner advertisements, Welles has no practical way of describing herself without using trademarked terms. In the context of metatags, we conclude that she has no practical way of identifying the content of her website without referring to PEI's trademarks.

. . .

Precluding their use would have the unwanted effect of hindering the free flow of information on the internet, something which is certainly not a goal of trademark law. Accordingly, the use of trademarked terms in the metatags meets the first part of the test for nominative use....We conclude that the metatags satisfy the second and third elements of the test as well. The metatags use only so much of the marks as reasonably necessary and nothing is done in conjunction with them to suggest sponsorship or endorsement by the trademark holder. We note that our decision might differ if the metatags listed the trademarked term so repeatedly that Welles' site would regularly appear above PEI's in searches for one of the trademarked terms.

3. Wallpaper/watermark.

The background, or wallpaper, of Welles' site consists of the repeated abbreviation "PMOY '81," which stands for "Playmate of the Year 1981." Welles' name or likeness does not appear before or after "PMOY '81." The pattern created by the repeated abbreviation appears as the background of the various pages of the website. Accepting, for the purposes of this appeal, that the abbreviation "PMOY" is indeed entitled to protection, we conclude that the repeated, stylized use of this abbreviation fails the nominative use test.

The repeated depiction of "PMOY '81" is not necessary to describe Welles. "Playboy Playmate of the Year 1981" is quite adequate. Moreover, the term does not even appear to describe Welles—her name or likeness do not appear before or after each "PMOY

'81." Because the use of the abbreviation fails the first prong of the nominative use test, we need not apply the next two prongs of the test.

Because the defense of nominative use fails here, and we have already determined that the doctrine of fair use does not apply, we remand to the district court. The court must determine whether trademark law protects the abbreviation "PMOY," as used in the wallpaper.

B. Trademark Dilution [At this point, the court considers and rejects PEI's claim for trademark dilution.]

Conclusion

For the foregoing reasons, we affirm the district court's grant of summary judgment as to PEI's claims for trademark infringement and trademark dilution, with the sole exception of the use of the abbreviation "PMOY." We reverse as to the abbreviation and remand for consideration of whether it merits protection under either an infringement or a dilution theory.

CASE QUESTIONS

1. Do you agree with the court's decision that there is no dilution here?
2. If PMOY is not a registered trademark, why does the court discuss it?
3. What does "nominative use" mean in the context of this case?
4. In business terms, why would PEI even think that it was losing money, or could lose money, based on Welles's use of its identifying marks?

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12.7: 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?

SELF-TEST QUESTIONS

1. Which of the following cannot be protected under patent, copyright, or trademark law? a. a synthesized molecule
   b. a one-line book title
   c. a one-line advertising jingle
   d. a one-word company name
2. Which of the following does not expire by law? a. a closely guarded trade secret not released to the public
   b. a patent granted by the US Patent and Trademark Office
   c. a copyright registered in the US Copyright Office
   d. a federal trademark registered under the Lanham Act
3. A sculptor casts a marble statue of a three-winged bird. To protect against copying, the sculptor can obtain which of the following? a. a patent
   b. a trademark
   c. a copyright
   d. none of the above

4. A stock analyst discovers a new system for increasing the value of a stock portfolio. He may protect against use of his system by other people by securing a. a patent
   b. a copyright
   c. a trademark
   d. none of the above
5. A company prints up its customer list for use by its sales staff. The cover page carries a notice that says “confidential.” A rival salesman gets a copy of the list. The company can sue to recover the list because the list is a. patented
   b. copyrighted
   c. a trade secret
   d. none of the above

SELF-TEST AnswerS

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

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13: SECURITIES REGULATION

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13.1: Chapter Introduction

Learning Objectives

After reading this chapter, you should understand the following:

1. The nature of securities regulation
2. The Securities Act of 1933 and the Securities Exchange Act of 1934
3. Liability under securities laws
4. What insider trading is and why it's unlawful
5. Civil and criminal penalties for violations of securities laws

In Chapter 26 "Legal Aspects of Corporate Finance", we examined state law governing a corporation's issuance and transfer of stock. In Chapter 27 "Corporate Powers and Management", we covered the liability of directors and officers. This chapter extends and ties together the themes raised in Chapter 26 "Legal Aspects of Corporate Finance" and Chapter 27 "Corporate Powers and Management" by examining government regulation of securities and insider trading. 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?

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13.2: The Nature of Securities Regulation

Learning Objectives

1. Recognize that the definition of *security* encompasses a broad range of interests.
2. Understand the functions of the Securities and Exchange Commission and the penalties for violations of the securities laws.
3. Understand which companies the Securities Exchange Act of 1934 covers.
4. Explore the purpose of state Blue Sky Laws.
5. 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 (see Chapter 25 "Corporation: General Characteristics and Formation").

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 Supreme Court ruled that notes that are not "investment contracts" under the *Howey* test can still be considered securities if certain factors are present, as discussed in *Reves v. Ernst & Young*, (see Section 28.3.1 "What Is a Security?"). These factors include (1) the motivations prompting a reasonable seller and buyer to enter into the transaction, (2) the plan of distribution and whether the instruments are commonly traded for speculation or investment, (3) the reasonable expectations of the investing public, and (4) the presence of other factors that significantly reduce risk so as to render the application of the Securities Act

unnecessary.

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 "Administrative Law"). 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. Other exemptions include the following: (1) private offerings to a limited number of persons or institutions who have access to the kind of information registration would disclose and who do not propose to redistribute the securities; (2) offerings restricted to the residents of the state in which the issuing company is organized and doing business; (3) securities of municipal, state, federal and other government instrumentalities, of charitable institutions, of banks, and of carriers subject to the Interstate Commerce Act; (4) offerings not in excess of certain specified amounts made in compliance with regulations of the Commission...: and (5) offerings of "small business investment companies" made in accordance with rules and regulations of the Commission.

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.

Although these civil penalty provisions apply only to false statements in connection with the registration statement, prospectus, or oral communication, the Supreme Court held, in *Case v. Borak*,*Case v. Borak*, 377 U.S. 426 (1964). that there is an "**implied private right of action**" for damages resulting from a violation of SEC rules under the act. The Court's ruling in *Borak* opened the courthouse doors to many who had been defrauded but were previously without a practical remedy.

Securities Exchange Act of 1934

Companies Covered

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.

Reporting Proxy Solicitation

Any company seeking listing and registration of its stock for public trading on a national exchange—or over the counter, if the company meets the size test—must first submit a registration application to both the exchange and the SEC. The registration statement is akin to that filed by companies under the Securities Act of 1933, although the Securities Exchange Act of 1934 calls for somewhat fewer disclosures. Thereafter, companies must file annual and certain other periodic reports to update information in the original filing.

The Securities Exchange Act of 1934 also covers **proxy solicitation**. Whenever management, or a dissident minority, seeks votes of holders of registered securities for any corporate purpose, disclosures must be made to the stockholders to permit them to vote yes or no intelligently.

Penalties

The logic of the *Borak* case (discussed in Section 28.1.3 "Securities Act of 1933") also applies to this act, so that private investors may bring suit in federal court for violations of the statute that led to financial injury. Violations of any provision and the making of false statements in any of the required disclosures subject the defendant to a maximum fine of $5 million and a maximum twenty-year prison sentence, but a defendant who can show that he had no knowledge of the particular rule he was convicted of violating may not be imprisoned. The maximum fine for a violation of the act by a person other than a natural person is $25 million. Any issuer omitting to file requisite documents and reports is liable to pay a fine of $100 for each day the failure continues.

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 28.1.3 "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.

Many of the blue sky laws are inconsistent with each other, making national uniformity difficult. In 1956, the National Conference of Commissioners on Uniform State Laws approved the Uniform Securities Act. It has not been designed to reconcile the conflicting philosophies of state regulation but to take them into account and to make the various forms of regulation as consistent as possible. States adopt various portions of the law, depending on their regulatory philosophies. The Uniform Securities Act has antifraud, broker-dealer registration, and securities registration provisions. More recent acts have further increased uniformity. These include the National Securities Markets Improvement Act of 1996, which preempted differing state philosophies with regard to registration of securities and regulation of brokers and advisors, and the Securities Litigation Uniform Standards Act of 1998, which preempted state law securities fraud claims from being raised in class action lawsuits by investors.

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.For more information on the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173), see Thomas, “Major Actions,” Bill Summary & Status 111th Congress (2009–2010) H.R.4173, thomas.loc.gov/cgi-bin/bdquer...ajor%20actions.

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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13.3: Liability under Securities Law

Learning Objectives

1. Understand how the Foreign Corrupt Practices Act prevents American companies from using bribes to enter into contracts or gain licenses from foreign governments.
2. 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.
3. 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.

But not all payments are illegal. Under 1988 amendments to the FCPA, payments may be made to expedite routine governmental actions, such as obtaining a visa. And payments are allowed if they are lawful under the written law of a foreign country. More important than the foreign-bribe provisions, the act includes accounting provisions, which broaden considerably the authority of the SEC. These provisions are discussed in *SEC v. World-Wide Coin Investments, Ltd.*,*SEC v. World-Wide Coin Investments, Ltd.*, 567 F.Supp. 724 (N.D. Ga. 1983). the first accounting provisions case brought to trial.

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.

Because of the unfairness to those who are ignorant of inside information, federal law prohibits **insider trading**. Two provisions of the 1934 Securities Exchange Act are paramount: **Section 16(b)** and 10(b).

Recapture of Short-Swing Profits: Section 16(b)

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).

As a consequence of Section 16(b) and certain other provisions, trading in securities by directors, officers, and large stockholders presents numerous complexities. For instance, the law requires people in this position to make periodic reports to the SEC about their trades. As a practical matter, directors, officers, and large shareholders should not trade in their own company stock in the short run without legal advice.

Insider Trading: Section 10(b) and Rule 10b-5

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.

Insider trading ran headlong into Rule 10b-5 beginning in 1964 in a series of cases involving Texas Gulf Sulphur Company (TGS). On November 12, 1963, the company discovered a rich deposit of copper and zinc while drilling for oil near Timmins, Ontario. Keeping the discovery quiet, it proceeded to acquire mineral rights in adjacent lands. By April 1964, word began to circulate about TGS's find.

Newspapers printed rumors, and the Toronto Stock Exchange experienced a wild speculative spree. On April 12, an executive vice president of TGS issued a press release downplaying the discovery, asserting that the rumors greatly exaggerated the find and stating that more drilling would be necessary before coming to any conclusions. Four days later, on April 16, TGS publicly announced that it had uncovered a strike of 25 million tons of ore. In the months following this announcement, TGS stock doubled in value.

The SEC charged several TGS officers and directors with having purchased or told their friends, so-called **tippees**, to purchase TGS stock from November 12, 1963, through April 16, 1964, on the basis of material inside information. The SEC also alleged that the April 12, 1964, press release was deceptive. The US Court of Appeals, in *SEC v. Texas Gulf Sulphur Co.*,*SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968). decided that the defendants who purchased the stock before the public announcement had violated Rule 10b-5. According to the court, "anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed." On remand, the

district court ordered certain defendants to pay $148,000 into an escrow account to be used to compensate parties injured by the insider trading.

The court of appeals also concluded that the press release violated Rule 10b-5 if "misleading to the reasonable investor." On remand, the district court held that TGS failed to exercise "due diligence" in issuing the release. Sixty-nine private damage actions were subsequently filed against TGS by shareholders who claimed they sold their stock in reliance on the release. The company settled most of these suits in late 1971 for $2.7 million.

Following the TGS episode, the Supreme Court refined Rule 10b-5 on several fronts. First, in *Ernst & Ernst v. Hochfelder*,*Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). the Court decided that proof of **scienter**—defined as "mental state embracing intent to deceive, manipulate, or defraud"—is required in private damage actions under Rule 10b-5. In other words, negligence alone will not result in Rule 10b-5 liability. The Court also held that scienter, which is an intentional act, must be established in SEC injunctive actions.*Aaron v. SEC*, 446 U.S. 680 (1980).

The Supreme Court has placed limitations on the liability of tippees under Rule 10b-5. In 1980, the Court reversed the conviction of an employee of a company that printed tender offer and merger prospectuses. Using information obtained at work, the employee had purchased stock in target companies and later sold it for a profit when takeover attempts were publicly announced. In *Chiarella v. United States*, the Court held that the employee was not an insider or a fiduciary and that "a duty to disclose under Section 10(b) does not arise from the mere possession of nonpublic market information."*Chiarella v. United States*, 445 U.S. 222 (1980). Following *Chiarella*, the Court ruled in *Dirks v. Securities and Exchange Commission* (see Section 28.3.2 "Tippee Liability"), that tippees are liable if they had reason to believe that the tipper breached a fiduciary duty in disclosing confidential information and the tipper received a personal benefit from the disclosure.

The Supreme Court has also refined Rule 10b-5 as it relates to the duty of a company to disclose **material information**, as discussed in *Basic, Inc. v. Levinson* (see Section 28.3.3 "Duty to Disclose Material Information"). This case is also important in its discussion of the degree of reliance investors must prove to support a Rule 10b-5 action.

In 2000, the SEC enacted **Rule 10b5-1**, which defines trading "on the basis of" inside information as any time a person trades while aware of material nonpublic information. Therefore, a defendant is not saved by arguing that the trade was made independent of knowledge of the nonpublic information. However, the rule also creates an affirmative defense for trades that were planned prior to the person's receiving inside information.

In addition to its decisions relating to intent (*Ernst & Ernst*), tippees (*Dirks*), materiality (*Basic*), and awareness of nonpublic information (10b5-1), the Supreme Court has considered the **misappropriation theory**, under which a person who misappropriates information from an employer faces insider trading liability. In a leading misappropriation theory case, the Second Circuit Court of Appeals reinstated an indictment against employees who traded on the basis of inside information obtained through their work at investment banking firms. The court concluded that the employees' violation of their fiduciary duty to the firms violated securities law.*United States v. Newman*, 664 F.2d 12 (2d Cir. 1981). The US Supreme Court upheld the misappropriation theory in *United States v. O'Hagan*,*United States v. O'Hagan*, 521 U.S. 642 (1997). and the SEC adopted the theory as new **Rule 10b5-2**. Under this new rule, the duty of trust or confidence exists when (1) a person agrees to maintain information in confidence; (2) the recipient knows or should have known through history, pattern, or practice of sharing confidences that the person communicating the information expects confidentiality; and (3) a person received material nonpublic information from his or her spouse, parent, child, or sibling.

In 1987, in *Carpenter v. United States*,*Carpenter v. United States*, 484 U.S. 19 (1987). the Supreme Court affirmed the conviction of a *Wall Street Journal* reporter who leaked advanced information about the contents of his "Heard on the Street" column. The reporter, who was sentenced to eighteen months in prison, had been convicted on both mail and wire fraud and securities law charges for misappropriating information. The Court upheld the mail and wire fraud conviction by an 8–0 vote and the securities law conviction by a 4–4 vote. (In effect, the tie vote affirmed the conviction.)*Carpenter v. United States*, 484 U.S. 19 (1987).

Beyond these judge-made theories of liability, 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. For the SEC release on the Martha Stewart case, see http://www.sec.gov/news/press/2003-69.htm.

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.

Secondary Actor

In *Stoneridge Investment Partners v. Scientific-Atlanta*,*Stoneridge Investment Partners v. Scientific-Atlanta*, 552 U.S. 148 (2008). the US Supreme Court held that "aiders and abettors" of fraud cannot be held secondarily liable under 10(b) for a private cause of action. This means that **secondary actors**, such as lawyers and accountants, cannot be held liable unless their conduct satisfies all the elements for 10(b) liability.

For an overview of insider trading, go to http://www.sec.gov/answers/insider.htm.

Sarbanes-Oxley Act

Congress enacted the Sarbanes-Oxley Act in 2002 in response to major corporate and accounting scandals, most notably those involving Enron, Tyco International, Adelphia, and WorldCom. The act created the **Public Company Accounting Oversight Board**, which oversees, inspects, and regulates accounting firms in their capacity as auditors of public companies. As a result of the act, the SEC may include civil penalties to a disgorgement fund for the benefit of victims of the violations of the Securities Act of 1933 and the Securities Exchange Act of 1934.

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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13.4: Cases

What Is a Security?

Reves v. Ernst & Young

494 U.S. 56, 110 S.Ct. 945 (1990)

JUSTICE MARSHALL delivered the opinion of the Court.

This case presents the question whether certain demand notes issued by the Farmer's Cooperative of Arkansas and Oklahoma are "securities" within the meaning of § 3(a)(10) of the Securities and Exchange Act of 1934. We conclude that they are.

The Co-Op is an agricultural cooperative that, at the same time relevant here, had approximately 23,000 members. In order to raise money to support its general business operations, the Co-Op sold promissory notes payable on demand by the holder. Although the notes were uncollateralized and uninsured, they paid a variable rate of interest that was adjusted monthly to keep it higher than the rate paid by local financial institutions. The Co-Op offered the notes to both members and nonmembers, marketing the scheme as an "Investment Program." Advertisements for the notes, which appeared in each Co-Op newsletter, read in part: "YOUR CO-OP has more than $11,000,000 in assets to stand behind your investments. The Investment is not Federal [sic] insured but it is...Safe...Secure...and available when you need it." App. 5 (ellipses in original). Despite these assurances, the Co-Op filed for bankruptcy in 1984. At the time of the filing, over 1,600 people held notes worth a total of $10 million.

After the Co-Op filed for bankruptcy, petitioners, a class of holders of the notes, filed suit against Arthur Young & Co., the firm that had audited the Co-Op's financial statements (and the predecessor to respondent Ernst & Young). Petitioners alleged, inter alia, that Arthur Young had intentionally failed to follow generally accepted accounting principles in its audit, specifically with respect to the valuation of one of the Co-Op's major assets, a gasohol plant. Petitioners claimed that Arthur Young violated these principles in an effort to inflate the assets and net worth of the Co-Op. Petitioners maintained that, had Arthur Young properly treated the plant in its audits, they would not have purchased demand notes because the Co-Op's insolvency would have been apparent. On the basis of these allegations, petitioners claimed that Arthur Young had violated the antifraud provisions of the 1934 Act as well as Arkansas' securities laws.

Petitioners prevailed at trial on both their federal and state claims, receiving a $6.1 million judgment. Arthur Young appealed, claiming that the demand notes were not "securities" under either the 1934 Act or Arkansas law, and that the statutes' antifraud provisions therefore did not apply. A panel of the Eighth Circuit, agreeing with Arthur Young on both the state and federal issues, reversed. Arthur Young & Co. v. Reves, 856 F.2d 52 (1988). We granted certiorari to address the federal issue, 490 U.S. 1105, 109 S.Ct. 3154, 104 L.Ed.2d 1018 (1989), and now reverse the judgment of the Court of Appeals.

* * *

The fundamental purpose undergirding the Securities Acts is "to eliminate serious abuses in a largely unregulated securities market." United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 849, 95 S.Ct. 2051, 2059, 44 L.Ed.2d 621 (1975). In defining the scope of the market that it wished to regulate, Congress painted with a broad brush. It recognized the virtually limitless scope of human ingenuity, especially in the creation of "countless and variable schemes devised by those who seek the use of the money of others on the promise of profits," SEC v. W.J. Howey Co., 328 U.S. 293, 299, 66 S.Ct. 1100, 1103, 90 L.Ed. 1244 (1946), and determined that the best way to achieve its goal of protecting investors was "to define 'the term "security" in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.'" Forman, supra, 421 U.S., at 847-848, 95 S.Ct., at 2058-2059 (quoting H.R.Rep. No. 85, 73d Cong., 1st Sess., 11 (1933)). Congress therefore did not attempt precisely to cabin the scope of the Securities Acts. Rather, it enacted a definition of "security" sufficiently broad to encompass virtually any instrument that might be sold as an investment.

* * *

[In deciding whether this transaction involves a "security," four factors are important.] First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and

sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security." Second, we examine the "plan of distribution" of the instrument to determine whether it is an instrument in which there is "common trading for speculation or investment." Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction. Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.

* * *

[We] have little difficulty in concluding that the notes at issue here are "securities."

CASE QUESTIONS

1. What are the four factors the court uses to determine whether or not the transaction involves a security?
2. How does the definition of security in this case differ from the definition in *Securities & Exchange Commission v. W. J. Howey*?

Tippee Liability

Dirks v. Securities and Exchange Commission

463 U.S. 646 (1983)

[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.

* * *

Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure. This standard was identified by the SEC itself in Cady, Roberts: a purpose of the securities laws was to eliminate "use of inside information for personal advantage." Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.

* * *

Under the inside-trading and tipping rules set forth above, we find that there was no actionable violation by Dirks. It is undisputed that Dirks himself was a stranger to Equity Funding, with no preexisting fiduciary duty to its shareholders. He took no action, directly, or indirectly, that induced the shareholders or officers of Equity Funding to repose trust or confidence in him. There was no expectation by Dirk's sources that he would keep their information in confidence. Nor did Dirks misappropriate or illegally obtain the information about Equity Funding. Unless the insiders breached their Cady, Roberts duty to shareholders in disclosing the nonpublic information to Dirks, he breached no duty when he passed it on to investors as well as to the Wall Street Journal.

* * *

It is clear that neither Secrist nor the other Equity Funding employees violated their Cady, Roberts duty to the corporation's shareholders by providing information to Dirks. The tippers received no monetary or personal benefit for revealing Equity Funding's secrets, nor was their purpose to make a gift of valuable information to Dirks. As the facts of this case clearly indicate, the tippers were motivated by a desire to expose the fraud. In the absence of a breach of duty to shareholders by the insiders, there was no derivative breach by Dirks. Dirks therefore could not have been "a participant after the fact in [an] insider's breach of a fiduciary duty." Chiarella, 445 U.S., at 230, n. 12.

* * *

We conclude that Dirks, in the circumstances of this case, had no duty to abstain from the use of the inside information that he

obtained. The judgment of the Court of Appeals therefore is reversed.

CASE QUESTIONS

1. When does a tippee assume a fiduciary duty to shareholders of a corporation?
2. Did Dirks violate any insider trading laws? Why or why not?
3. How does this case refine Rule 10b-5?

Duty to Disclose Material Information

Basic Inc v. Levinson

485 U.S. 224 (1988)

[In December 1978, Basic Incorporated agreed to merge with Consolidated Engineering. Prior to the merger, Basic made three public statements denying it was involved in merger negotiations. Shareholders who sold their stock after the first of these statements and before the merger was announced sued Basic and its directors under Rule 10b-5, claiming that they sold their shares at depressed prices as a result of Basic's misleading statements. The district court decided in favor of Basic on the grounds that Basic's statements were not material and therefore were not misleading. The court of appeals reversed, and the Supreme Court granted certiorari.]

JUSTICE BLACKMUN.

We granted certiorari to resolve the split among the Courts of Appeals as to the standard of materiality applicable to preliminary merger discussions, and to determine whether the courts below properly applied a presumption of reliance in certifying the class, rather than requiring each class member to show direct reliance on Basic's statements.

* * *

The Court previously has addressed various positive and common-law requirements for a violation of § 10(b) or of Rule 10b-5. The Court also explicitly has defined a standard of materiality under the securities laws, see TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976), concluding in the proxy-solicitation context that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."...We now expressly adopt the TSC Industries standard of materiality for the 5 10(b) and Rule 10b-5 context.

The application of this materiality standard to preliminary merger discussions is not self-evident. Where the impact of the corporate development on the target's fortune is certain and clear, the TSC Industries materiality definition admits straightforward application. Where, on the other hand, the event is contingent or speculative in nature, it is difficult to ascertain whether the "reasonable investor" would have considered the omitted information significant at the time. Merger negotiations, because of the ever-present possibility that the contemplated transaction will not be effectuated, fall into the latter category.

* * *

Even before this Court's decision in TSC Industries, the Second Circuit had explained the role of the materiality requirement of Rule 10b-5, with respect to contingent or speculative information or events, in a manner that gave that term meaning that is independent of the other provisions of the Rule. Under such circumstances, materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." SEC v. Texas Gulf Sulphur Co., 401 F.2d, at 849.

* * *

Whether merger discussions in any particular case are material therefore depends on the facts. Generally, in order to assess the probability that the event will occur, a factfinder will need to look to indicia of interest in the transactions at the highest corporate levels. Without attempting to catalog all such possible factors, we note by way of example that board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries may serve as indicia of interest. To assess the magnitude of the transaction to the issuer of the securities allegedly manipulated, a factfinder will need to consider such facts as the size of the two corporate entities and of the potential premiums over market value. No particular event or factor short of closing the transaction need to be either necessary or sufficient by itself to render merger discussions material.

As we clarify today, materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information. The fact-specific inquiry we endorse here is consistent with the approach a number of courts have taken in assessing the materiality of merger negotiations. Because the standard of materiality we have adopted differs from that used by both courts below, we remand the case for reconsideration of the question whether a grant of summary judgment is appropriate on this record.

We turn to the question of reliance and the fraud on-the-market theory. Succinctly put:

The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available information regarding the company and its business....Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements....The causal connection between the defendants' fraud and the plaintiff's purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations. Peil v. Speiser, 806 F.2d 1154, 1160-1161 (CA3 1986).

* * *

We agree that reliance is an element of a Rule 10b-5 cause of action. Reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's misrepresentation and a plaintiff's injury. There is, however, more than one way to demonstrate the causal connection.

* * *

Presumptions typically serve to assist courts in managing circumstances in which direct proof, for one reason or another, is rendered difficult. The courts below accepted a presumption, created by the fraud-on-the-market theory and subject to rebuttal by petitioners, that persons who had traded Basic shares had done so in reliance on the integrity of the price set by the market, but because of petitioners' material misrepresentations that price had been fraudulently depressed. Requiring a plaintiff to show a speculative state of facts, i.e., how he would have acted if omitted material information had been disclosed, or if the misrepresentation had not been made, would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market.

Arising out of considerations of fairness, public policy, and probability, as well as judicial economy, presumptions are also useful devices for allocating the burdens of proof between parties. The presumption of reliance employed in this case is consistent with, and, by facilitating Rule 10b-5 litigation, supports, the congressional policy embodied in the 1934 Act....

The presumption is also supported by common sense and probability. Recent empirical studies have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations. It has been noted that "it is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?" Schlanger v. Four-Phase Systems, Inc., 555 F.Supp. 535, 538 (SDNY 1982)....An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.

* * *

The judgment of the Court of Appeals is vacated and the case is remanded to that court for further proceedings consistent with this opinion.

CASE QUESTIONS

1. How does the court determine what is or is not material information? How does this differ from its previous rulings?
2. What is the fraud-on-the-market theory?

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13.5: 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. Anne operated a clothing store called Anne's Rags, Inc. She owned all of the stock in the company. After several years in the clothing business, Anne sold her stock to Louise, who personally managed the business. Is the sale governed by the antifraud provisions of federal securities law? Why?
2. While waiting tables at a campus-area restaurant, you overhear a conversation between two corporate executives who indicate that their company has developed a new product that will revolutionize the computer industry. The product is to be announced in three weeks. If you purchase stock in the company before the announcement, will you be liable under federal securities law? Why?
3. Eric was hired as a management consultant by a major corporation to conduct a study, which took him three months to complete. While working on the study, Eric learned that someone working in research and development for the company had recently made an important discovery. Before the discovery was announced publicly, Eric purchased stock in the company. Did he violate federal securities law? Why?
4. While working for the company, Eric also learned that it was planning a takeover of another corporation. Before announcement of a tender offer, Eric purchased stock in the target company. Did he violate securities law? Why?
5. The commercial lending department of First Bank made a substantial loan to Alpha Company after obtaining a favorable confidential earnings report from Alpha. Over lunch, Heidi, the loan officer who handled the loan, mentioned the earnings report to a friend who worked in the bank's trust department. The friend proceeded to purchase stock in Alpha for several of the bank's trusts. Discuss the legal implications.
6. In Exercise 5, assume that a week after the loan to Alpha, First Bank financed Beta Company's takeover of Alpha. During the financing negotiations, Heidi mentioned the Alpha earnings report to Beta officials; furthermore, the report was an important factor in Heidi's decision to finance the takeover. Discuss the legal implications.
7. In Exercise 6, assume that after work one day, Heidi told her friend in the trust department that Alpha was Beta's takeover target. The friend proceeded to purchase additional stock in Alpha for a bank trust he administered. Discuss the legal implications.

SELF-TEST QUESTIONS

1. The issuance of corporate securities is governed by a. various federal statutes
   b. state law
   c. both of the above
   d. neither of the above
2. The law that prohibits the payment of a bribe to foreign officials to gain business is called a. the Insider Trading Act
   b. the blue sky law
   c. the Foreign Corrupt Practices Act
   d. none of the above
3. The primary means for banning stock offerings that inadequately disclose risks is a. the registration requirement
   b. SEC prohibition of risky stock offerings
   c. both of the above
   d. neither of the above
4. To enforce its prohibition under insider trading, the SEC requires reimbursement to the company of any profits made from selling and buying stock during any six-month period by directors owing a. 60 percent or more of company stock
   b. 40 percent or more of company stock
   c. 10 percent or more of company stock
   d. none of the above
5. Under Rule 10b-5, insiders include a. all company employees
   b. any person who possesses nonpublic information
   c. all tippees
   d. none of the above
6. The purpose of the Dodd-Frank Act is to a. promote financial stability
   b. end “too big to fail”
   c. end bailouts
   d. protect against abusive financial services practices
   e. all of the above

SELF-TEST AnswerS

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

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13.6.1: Chapter Introduction

Learning Objectives

After reading this chapter, you should understand the following:

1. How common-law employment at will is modified by common-law doctrine, federal statutes, and state statutes
2. Various kinds of prohibited discrimination under Title VII and examples of each kind
3. 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 the next 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. 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.

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13.6: EMPLOYMENT LAW

13.6.1: Chapter Introduction
13.6.2: Federal Employment Discrimination Laws
13.6.3: Employment at Will
13.6.4: Other Employment-Related Laws
13.6.5: Cases
13.6.6: Summary and Exercises

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13.6.2: Federal Employment Discrimination Laws

Learning Objectives

1. Know the various federal discrimination laws and how they are applied in various cases.
2. Distinguish between disparate impact and disparate treatment cases.
3. 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.

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 Young Americans for Freedom in the right wing of the GOP 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.See CongressLink, "Major Features of the Civil Rights Act of 1964," at http://www.congresslink.org/print_ba...ghts64text.htm.

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 30.1 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 (or gender) discrimination. *Barbano v. Madison County* (see Section 30.4.1 "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 "Introduction to Law and Legal Systems", Section 1.6 "A Sample Case"), 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 30.4.2 "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.

Sex discrimination in terms of wages and benefits is common enough that a number of sizeable class action lawsuits have been brought. A class action lawsuit is generally initiated by one or more people who believe that they, along with a group of other people, have been wronged in similar ways. Class actions for sexual harassment have been successful in the past. On June 11, 1998, the EEOC reached a $34 million settlement with Mitsubishi over allegations of widespread sexual harassment at the

Normal, Illinois, auto plant. The settlement involved about five hundred women who split the $34 million, although only seven received the maximum $300,000 allowed by law. The others received amounts ranging from $8,000 to $225,000.

Class action lawsuits involve specific plaintiffs (called class plaintiffs or class representatives) who are named in the class action lawsuit to assert the claims of the unnamed or absent members of the class; thus all those with a common complaint need not file their own separate lawsuit. From the point of view of plaintiffs who may have lost only a few thousand dollars annually as a result of the discrimination, a class action is advantageous: almost no lawyer would take a complicated civil case that had a potential gain of only a few thousand dollars. But if there are thousands of plaintiffs with very similar claims, the judgment could be well into the millions. Defendants can win the procedural battle by convincing a court that the proposed class of plaintiffs does not present common questions of law or of fact.

In the Wal-Mart class action case decided by the Supreme Court in 2011, three named plaintiffs (Dukes, Arana, and Kwapnoski) represented a proposed class of 1.5 million current or former Wal-Mart employees. The plaintiffs' attorneys asked the trial court in 2001 to certify as a class all women employed at any Wal-Mart domestic retail store at any time since December of 1998. As the case progressed through the judicial system, the class grew in size. If the class was certified, and discrimination proven, Wal-Mart could have been liable for over $1 billion in back pay. So Wal-Mart argued that as plaintiffs, the cases of the 1.5 million women did not present common questions of law or of fact—that is, that the claims were different enough that the Court should not allow a single class action lawsuit to present such differing kinds of claims. Initially, a federal judge disagreed, finding the class sufficiently coherent for purposes of federal civil procedure. The US Court of Appeals for the Ninth Circuit upheld the trial judge on two occasions.

But the US Supreme Court agreed with Wal-Mart. In the majority opinion, Justice Scalia discussed the commonality condition for class actions.

Quite obviously, the mere claim by employees of the same company that they have suffered a Title VII injury, or even a disparate impact Title VII injury, gives no cause to believe that all their claims can productively be litigated at once. Their claims must depend upon a common contention—for example, the assertion of discriminatory bias on the part of the same supervisor. That common contention, moreover, must be of such a nature that it is capable of classwide resolution—which means that determination of its truth or falsity will resolve an issue that is central to the validity of each one of the claims in one stroke.564 U.S. ___ (2011).

Finding that there was no common contention, the Supreme Court reversed the lower courts. Many commentators, and four dissenting Justices, believed that the majority opinion has created an unnecessarily high hurdle for class action plaintiffs in Title VII cases.

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. With regard to sex (gender), allowing women to be locker-room attendants only in a women's gym is a valid BFOQ. 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. With regard to national origin, directors of movies and theatrical productions would be within their Title VII BFOQ rights to restrict the roles of fictional Asians to those actors whose national origin was Asian, but could also permissibly hire Caucasian actors made up in "yellow face."

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 Raton*Faragher 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*,*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 30.4.3 "Age Discrimination: Burden of Persuasion") makes clear. It is now more difficult to prove an age discrimination claim than a claim under Title VII.

Disabilities: Discrimination against the Handicapped

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. (See Section 30.4.4 "Disability Discrimination".)

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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13.6.3: Employment at Will

Learning Objectives

1. Understand what is meant by employment at will under common law.
2. 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*,*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.) The court of appeals had reversed the trial court, and the Supreme Court had to decide if the professional code of Colorado accountants could be considered to be part of public policy. Given that accountants were licensed by the state on behalf of the public, and that the Board of Accountancy had published a code for accounting professionals and required an oath before licensing, the court noted the following:

The Colorado State Board of Accountancy is established pursuant to section 12-2-103, 5A C.R.S. (1991). The Board has responsibility for making appropriate rules of professional conduct, in order to establish and maintain a high standard of integrity in the profession of public accounting. § 12-2-104, 5A C.R.S. (1991). These rules of professional conduct govern every person practicing as a certified public accountant. Id. Failure to abide by these rules may result in professional discipline. § 12-2-123, 5A C.R.S. (1991). The rules of professional conduct for accountants have an important public purpose. They ensure the accurate reporting of financial information to the public. They allow the public and the business community to rely with confidence on financial reporting. Rule 7.1, 3 C.C.R. 705-1 (1991). In addition, they ensure that financial information will be reported consistently across many businesses. The legislature has endorsed these goals in section 12-2-101, 5A C.R.S.

The court went on to note that the stated purpose of the licensing and registration of certified public accountants was to “provide for the maintenance of high standards of professional conduct by those so licensed and registered as certified public accountants.” Further, the specific purpose of Rule 7.1 provided a clear mandate to support an action for wrongful discharge. Rule 7.1 is entitled “Integrity and Objectivity” and states, “A certificate holder shall not in the performance of professional services knowingly misrepresent facts, nor subordinate his judgment to others.” The fact that Mariani’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. This is not the majority view, as the case in Section 30.4.4 "Disability Discrimination" makes clear.

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 Compuserve, 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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13.6.4: Other Employment-Related Laws

Learning Objectives

1. 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 1988 estimate put the total held in pension funds at more than $1 *trillion*, costing the federal Treasury nearly $60 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. Multiemployer 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. 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 antidiscrimination 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." Two states and more than seventy counties or 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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13.6.5: Cases

Disparate Treatment: Burdens of Proof

Barbano v. Madison County

922 F.2d 139 (2d Cir. 1990)

Factual Background

At the Madison County (New York State) Veterans Service Agency, the position of director became vacant. The County Board of Supervisors created a committee of five men to hold interviews for the position. The committee interviewed Maureen E. Barbano and four others. When she entered the interview room, she heard someone say, “Oh, another woman.” At the beginning of the interview, Donald Greene said he would not consider “some woman” for the position. Greene also asked Barbano some personal questions about her family plans and whether her husband would mind if she transported male veterans. Ms. Barbano answered that the questions were irrelevant and discriminatory. However, Greene replied that the questions were relevant because he did not want to hire a woman who would get pregnant and quit. Another committee member, Newbold, agreed that the questions were relevant, and no committee member said the questions were not relevant.

None of the interviewers rebuked Greene or objected to the questions, and none of them told Barbano that she need not answer them. Barbano did state that if she decided to have a family she would take no more time off than medically necessary. Greene once again asked whether Barbano’s husband would object to her “running around the country with men” and said he would not want his wife to do it. Barbano said she was not his wife. The interview concluded after Barbano asked some questions about insurance.

After interviewing several other candidates, the board hired a man. Barbano sued the county for sex discrimination in violation of Title VII, and the district court held in her favor. She was awarded $55,000 in back pay, prejudgment interest, and attorney’s fees. Madison County appealed the judgment of Federal District Judge McAvoy; Barbano cross-appealed, asking for additional damages.

The court then found that Barbano had established a prima facie case of discrimination under Title VII, thus bringing into issue the appellants’ purported reasons for not hiring her. The appellants provided four reasons why they chose Wagner over Barbano, which the district court rejected either as unsupported by the record or as a pretext for discrimination in light of Barbano’s interview. The district court then found that because of Barbano’s education and experience in social services, the appellants had failed to prove that absent the discrimination, they still would not have hired Barbano. Accordingly, the court awarded Barbano back pay, prejudgment interest, and attorney’s fees. Subsequently, the court denied Barbano’s request for front pay and a mandatory injunction ordering her appointment as director upon the next vacancy. This appeal and cross-appeal followed.

From the Opinion of FEINBERG, CIRCUIT JUDGE

Appellants argue that the district court erred in finding that Greene’s statements during the interview showed that the Board discriminated in making the hiring decision, and that there was no direct evidence of discrimination by the Board, making it improper to require that appellants prove that they would not have hired Barbano absent the discrimination. Barbano in turn challenges the adequacy of the relief awarded to her by the district court.

A. Discrimination

At the outset, we note that Judge McAvoy’s opinion predated Price Waterhouse v. Hopkins, 490 U.S. 228, 109 S. Ct. 1775, 104 L. Ed. 2d 268 (1990), in which the Supreme Court made clear that a “pretext” case should be analyzed differently from a “mixed motives” case. *Id.* 109 S. Ct. at 1788-89. Judge McAvoy, not having the benefit of the Court’s opinion in Price Waterhouse, did not clearly distinguish between the two types of cases in analyzing the alleged discrimination. For purposes of this appeal, we do not think it is crucial how the district court categorized the case. Rather, we need only concern ourselves with whether the district

court's findings of fact are supported by the record and whether the district court applied the proper legal standards in light of its factual findings.

Whether the case is one of pretext or mixed motives, the plaintiff bears the burden of persuasion on the issue of whether gender played a part in the employment decision. *Price Waterhouse v. Hopkins, at 1788*. Appellants contend that Barbano did not sustain her burden of proving discrimination because the only evidence of discrimination involved Greene's statements during the interview, and Greene was an elected official over whom the other members of the Board exercised no control. Thus, appellants maintain, since the hiring decision was made by the 19-member board, evidence of discrimination by one member does not establish that the Board discriminated in making the hiring decision.

We agree that discrimination by one individual does not necessarily imply that a collective decision-making body of which the individual is a member also discriminated. However, the record before us supports the district court's finding that the Board discriminated in making the hiring decision.

First, there is little doubt that Greene's statements during the interview were discriminatory. He said he would not consider "some woman" for the position. His questioning Barbano about whether she would get pregnant and quit was also discriminatory, since it was unrelated to a bona fide occupational qualification. King v. Trans World Airlines, 738 F.2d 255, 258 n.2 (8th Cir. 1984). Similarly, Greene's questions about whether Barbano's husband would mind if she had to "run around the country with men," and that he would not want his wife to do it, were discriminatory, since once again the questions were unrelated to bona fide occupational qualifications. *Hopkins*, at 1786.

Moreover, the import of Greene's discriminatory questions was substantial, since apart from one question about her qualifications, none of the interviewers asked Barbano about other areas that allegedly formed the basis for selecting a candidate. Thus, Greene's questioning constituted virtually the entire interview, and so the district court properly found that the interview itself was discriminatory.

Next, given the discriminatory tenor of the interview, and the acquiescence of the other Committee members to Greene's line of questioning, it follows that the judge could find that those present at the interview, and not merely Greene, discriminated against Barbano. Judge McAvoy pointed out that the Chairman of the Committee, Newbold, thought Greene's discriminatory questions were relevant. Significantly, Barbano protested that Greene's questions were discriminatory, but no one agreed with her or told her that she need not answer. Indeed, no one even attempted to steer the interview in another direction. This knowing and informed toleration of discriminatory statements by those participating in the interview constitutes evidence of discrimination by all those present. That each member was independently elected to the Board does not mean that the Committee itself was unable to control the course of the interview. The Committee had a choice of how to conduct the interview, and the court could find that the Committee exercised that choice in a plainly discriminatory fashion.

This discrimination directly affected the hiring decision. At the end of the interviewing process, the interviewers evaluated the candidates, and on that basis submitted a recommendation as to which candidate to hire for the position. "Evaluation does not occur in a vacuum. By definition, when evaluating a candidate to fill a vacant position, one compares that candidate against other eligible candidates." Berl v. County of Westchester, 849 F.2d 712, 715 (2d Cir. 1988). Appellants stipulated that Barbano was qualified for the position. Again, because Judge McAvoy could find that the evaluation of Barbano was biased by gender discrimination, the judge could also find that the Committee's recommendation to hire Wagner, which was the result of a weighing of the relative merits of Barbano, Wagner and the other eligible candidates, was necessarily tainted by discrimination.

The Board in turn unanimously accepted the Committee's recommendation to hire Wagner, and so the Board's hiring decision was made in reliance upon a discriminatory recommendation. The Supreme Court in Hopkins v. Price Waterhouse found that a collective decision-making body can discriminate by relying upon discriminatory recommendations, and we are persuaded that the reasoning in that case applies here as well.

In Hopkins' case against Price Waterhouse, Ann Hopkins, a candidate for partnership at the accounting firm of Price Waterhouse, alleged that she was refused admission as a partner because of sex discrimination. Hopkins's evidence of discrimination consisted largely of evaluations made by various partners. Price Waterhouse argued that such evidence did not prove that its internal Policy Board, which was the effective decision-maker as to partnership in that case, had discriminated. The Court rejected that argument and found the evidence did establish discrimination:

Hopkins showed that the partnership solicited evaluations from all of the firm's partners; that it generally relied very heavily on such evaluations in making its decision; that some of the partners' comments were the product of [discrimination]; and that the firm in no way disclaimed reliance on those particular comments, either in Hopkins' case or in the past. Certainly, a plausible—and, one might say, inevitable—conclusion to draw from this set of circumstances is that the Policy Board in making its decision did

in fact take into account all of the partners' comments, including the comments that were motivated by [discrimination].

Hopkins, at 1794.

In a very significant sense, Barbano presents an even stronger case of discrimination because the only recommendation the Board relied upon here was discriminatory, whereas in Price Waterhouse, not all of the evaluations used in the decision-making process were discriminatory. On the other hand, it is true that the discriminatory content of some of the evaluations in Price Waterhouse was apparent from reading them, whereas here, the recommendation was embodied in a resolution to the Board and a reading of the resolution would not reveal that it was tainted by discrimination. Nonetheless, the facts in this case show that the Board was put on notice before making the appointment that the Committee's recommendation was biased by discrimination.

Barbano was a member of the public in attendance at the Board meeting in March 1980 when the Board voted to appoint Wagner. Before the Board adopted the resolution appointing Wagner, Barbano objected and asked the Board if male applicants were asked the questions she was asked during the interview. At this point, the entire Board membership was alerted to the possibility that the Committee had discriminated against Barbano during her interview. The Committee members did not answer the question, except for Newbold, who evaded the issue by stating that he did not ask such questions. The Board's ability to claim ignorance at this point was even further undermined by the fact that the Chairman of the Board, Callahan, was present at many of the interviews, including Barbano's, in his role as Chairman of the Board. Callahan did not refute Barbano's allegations, implying that they were worthy of credence, and none of the Board members even questioned Callahan on the matter.

It is clear that those present understood Barbano was alleging that she had been subjected to discrimination during her interview. John Patane, a member of the Board who had not interviewed Barbano, asked Barbano whether she was implying that Madison County was not an equal opportunity employer. Barbano said yes. Patane said the County already had their "token woman." Callahan apologized to Barbano for "any improper remarks that may have been made," but an apology for discrimination does not constitute an attempt to eliminate the discrimination from the hiring decision. Even though the Board was aware of possible improprieties, it made no investigation whatsoever into the allegations and did not disclaim any reliance upon the discrimination. In short, the circumstances show the Board was willing to rely on the Committee's recommendation even if Barbano had been discriminated against during her interview. On these facts, it was not clearly erroneous for the district court to conclude that Barbano sustained her burden of proving discrimination by the Board.

B. The Employer's Burden

Having found that Barbano carried her burden of proving discrimination, the district court then placed the burden on appellants to prove by a preponderance of the evidence that, absent the discrimination, they would not have hired Barbano for the position. Appellants argue that this burden is only placed on an employer if the plaintiff proves discrimination by direct evidence, and since Barbano's evidence of discrimination was merely circumstantial, the district court erred by placing the burden of proof on them. Appellants, however, misapprehend the nature of Barbano's proof and thus the governing legal standard.

The burden is properly placed on the defendant "once the plaintiff establishes by direct evidence that an illegitimate factor played a motivating or substantial role in an employment decision." Grant v. Hazelett Strip-Casting Corp., 880 F.2d 1564, 1568 (2d Cir. 1989). Thus, the key inquiry on this aspect of the case is whether the evidence is direct, that is, whether it shows that the impermissible criterion played some part in the decision-making process. See *Hopkins*, at 1791; *Grant*, 880 F.2d at 1569. If plaintiff provides such evidence, the fact-finder must then determine whether the evidence shows that the impermissible criterion played a motivating or substantial part in the hiring decision. Grant, 880 F.2d at 1569.

As we found above, the evidence shows that Barbano's gender was clearly a factor in the hiring decision. That the discrimination played a substantial role in that decision is shown by the importance of the recommendation to the Board. As Rafte testified, the Board utilizes a committee system, and so the Board "usually accepts" a committee's recommendation, as it did here when it unanimously voted to appoint Wagner. Had the Board distanced itself from Barbano's allegations of discrimination and attempted to ensure that it was not relying upon illegitimate criteria in adopting the Committee's recommendation, the evidence that discrimination played a substantial role in the Board's decision would be significantly weakened. The Board showed no inclination to take such actions, however, and in adopting the discriminatory recommendation allowed illegitimate criteria to play a substantial role in the hiring decision.

The district court thus properly required appellants to show that the Board would not have hired Barbano in the absence of discrimination. "The employer has not yet been shown to be a violator, but neither is it entitled to the...presumption of good faith concerning its employment decisions. At this point the employer may be required to convince the fact-finder that, despite the smoke, there is no fire." *Hopkins*, at 1798-99 (O'Connor, J., concurring).

Judge McAvoy noted in his opinion that appellants claimed they chose Wagner over Barbano because he was better qualified in the following areas: (1) interest in veterans' affairs; (2) experience in the military; (3) tactfulness; and (4) experience supervising an office. The judge found that the evidence before him supported only appellants' first and second reasons for refusing to hire Barbano, but acknowledged that the Committee members "were enamored with Wagner's military record and involvement with veterans' organizations." However, neither of these is listed as a job requirement in the job description, although the district court found that membership in a veterans' organization may indicate an interest in veterans' affairs. Nonetheless, the district court found that given Barbano's "education and experience in social services," appellants failed to carry their burden of proving by a preponderance of the evidence that, absent discrimination, they would not have hired Barbano.

The district court properly held appellants to a preponderance of the evidence standard. *Hopkins*, 109 S. Ct. at 1795....

At the time of the hiring decision in 1980, Barbano had been a Social Welfare Examiner for Madison County for the three previous years. In this position, she determined the eligibility of individuals for public assistance, medicaid or food stamps, and would then issue or deny the individual's application based on all federal, state and local regulations pertaining to the program from which the individual was seeking assistance. Barbano was thus familiar with the operation of public assistance programs, knew how to fill out forms relating to benefits and had become familiar with a number of welfare agencies that could be of use to veterans. Barbano was also working towards an Associate Degree in Human Services at the time. Rafte testified that Barbano's resume was "very impressive." Moreover, Barbano, unlike Wagner, was a resident of Madison County, and according to Rafte, a candidate's residency in the county was considered to be an advantage. Finally, Barbano had also enlisted in the United States Marine Corps in 1976, but during recruit training had been given a vaccine that affected her vision. She had received an honorable discharge shortly thereafter.

Wagner had nine years experience as an Air Force Personnel Supervisor, maintaining personnel records, had received a high school equivalency diploma and took several extension classes in management. He had been honorably discharged from the Air Force in 1965 with the rank of Staff Sergeant. Wagner was a member of the American Legion, and his application for the position included recommendations from two American Legion members. However, for the six years prior to his appointment as Director, Wagner's sole paid employment was as a school bus driver and part-time bartender at the American Legion. Wagner admitted that before he was hired he had no knowledge of federal, state and local laws, rules and regulations pertaining to veterans' benefits and services, or knowledge of the forms, methods and procedures used to process veteran benefits claims. Wagner also had not maintained liaison with welfare agencies and was unfamiliar with the various welfare agencies that existed in the county.

To be sure, both candidates were qualified for the Director's position, and it is not our job—nor was it the district court's—to decide which one was preferable. However, there is nothing to indicate that Judge McAvoy misconceived his function in this phase of the case, which was to decide whether appellants failed to prove by a preponderance of the evidence that they would not have hired Barbano even if they had not discriminated against her. The judge found that defendants had not met that burden. We must decide whether that finding was clearly erroneous, and we cannot say that it was.

CASE QUESTIONS

1. Madison County contended that Barbano needed to provide "direct evidence" of discrimination that had played a motivating or substantial part in the decision. What would such evidence look like? Is it likely that most plaintiffs who are discriminated against because of their gender would be able to get "direct evidence" that gender was a motivating or substantial factor?
2. The "clearly erroneous" standard is applied here, as it is in many cases where appellate courts review trial court determinations. State the test, and say why the appellate court believed that the trial judge's ruling was not "clearly erroneous."

Title VII and Hostile Work Environment

Duncan v. General Motors Corporation

300 F.3d 928 (8th Cir. 2002)

OPINION BY HANSEN, Circuit Judge.

The Junior College District of St. Louis (the College) arranged for Diana Duncan to provide in-house technical training at General Motors Corporation's (GMC) manufacturing facility in Wentzville, Missouri. Throughout her tenure at GMC, Duncan was subjected to unwelcome attention by a GMC employee, James Booth, which culminated in Duncan's resignation. Duncan subsequently filed

this suit under Title VII of the Civil Rights Act and the Missouri Human Rights Act, see 42 U.S.C. §§ 2000e-2000e-17; Mo. Rev. Stat. §§ 213.010-213.137,[2] alleging that she was sexually harassed and constructively discharged. A jury found in favor of Duncan and awarded her $4600 in back pay, $700,000 in emotional distress damages on her sexual harassment claim, and $300,000 in emotional distress damages on her constructive discharge claim. GMC appeals from the district court's denial of its post trial motion for judgment as a matter of law, and the district court's award of attorneys' fees attendant to the post trial motion. We reverse.

I.

Diana Duncan worked as a technical training clerk in the high-tech area at GMC as part of the College's Center for Business, Industry, and Labor program from August 1994 until May 1997. Duncan provided in-house training support to GMC employees.

Duncan first learned about the College's position at GMC from Booth, a United Auto Workers Union technology training coordinator for GMC. Booth frequented the country club where Duncan worked as a waitress and a bartender. Booth asked Duncan if she knew anyone who had computer and typing skills and who might be interested in a position at GMC. Duncan expressed interest in the job. Booth brought the pre-employment forms to Duncan at the country club, and he forwarded her completed forms to Jerry Reese, the manager of operations, manufacturing, and training for the College. Reese arranged to interview Duncan at GMC. Reese, Booth, and Ed Ish, who was Booth's management counterpart in the high-tech area of the GMC plant, participated in the interview. Duncan began work at GMC in August 1994.

Two weeks after Duncan began working at GMC, Booth requested an off-site meeting with her at a local restaurant. Booth explained to Duncan that he was in love with a married coworker and that his own marriage was troubled. Booth then propositioned Duncan by asking her if she would have a relationship with him. Duncan rebuffed his advance and left the restaurant. The next day Duncan mentioned the incident to the paint department supervisor Joe Rolen, who had no authority over Booth. Duncan did not report Booth's conduct to either Reese (her supervisor) at the College or Ish (Booth's management counterpart) at GMC. However, she did confront Booth, and he apologized for his behavior. He made no further such "propositions." Duncan stated that Booth's manner toward her after she declined his advance became hostile, and he became more critical of her work. For example, whenever she made a typographical error, he told her that she was incompetent and that he should hire a "Kelly Services" person to replace her. Duncan admitted that Booth's criticisms were often directed at other employees as well, including male coworkers.

Duncan testified to numerous incidents of Booth's inappropriate behavior. Booth directed Duncan to create a training document for him on his computer because it was the only computer with the necessary software. The screen saver that Booth had selected to use on his computer was a picture of a naked woman. Duncan testified to four or five occasions when Booth would unnecessarily touch her hand when she handed him the telephone. In addition, Booth had a planter in his office that was shaped like a slouched man wearing a sombrero. The planter had a hole in the front of the man's pants that allowed for a cactus to protrude. The planter was in plain view to anyone entering Booth's office. Booth also kept a child's pacifier that was shaped like a penis in his office that he occasionally showed to his coworkers and specifically to Duncan on two occasions.

In 1995, Duncan requested a pay increase and told Booth that she would like to be considered for an illustrator's position. Booth said that she would have to prove her artistic ability by drawing his planter. Duncan objected, particularly because previous applicants for the position were required to draw automotive parts and not his planter. Ultimately, Duncan learned that she was not qualified for the position because she did not possess a college degree.

Additionally in 1995, Booth and a College employee created a "recruitment" poster that was posted on a bulletin board in the high-tech area. The poster portrayed Duncan as the president and CEO of the Man Hater's Club of America. It listed the club's membership qualifications as: "Must always be in control of: (1) Checking, Savings, all loose change, etc.; (2) (Ugh) Sex; (3) Raising children our way!; (4) Men must always do household chores; (5) Consider T.V. Dinners a gourmet meal."...

On May 5, 1997, Booth asked Duncan to type a draft of the beliefs of the "He-Men Women Hater's Club." The beliefs included the following:

—Constitutional Amendment, the 19th, giving women [the] right to vote should be repealed. Real He-Men indulge in a lifestyle of cursing, using tools, handling guns, driving trucks, hunting and of course, drinking beer.

—Women really do have coodies [sic] and they can spread.

—Women [are] the cause of 99.9 per cent of stress in men.

—Sperm has a right to live.

—All great chiefs of the world are men.

—Prostitution should be legalized.

Duncan refused to type the beliefs and resigned two days later.

Duncan testified that she complained to anyone who would listen to her about Booth's behavior, beginning with paint department supervisor Joe Rolen after Booth propositioned her in 1994. Duncan testified that between 1994 and 1997 she complained several times to Reese at the College about Booth's behavior, which would improve at least in the short term after she spoke with Reese....

Duncan filed a charge of sex discrimination with the Equal Employment Opportunity Commission (EEOC) on October 30, 1997. The EEOC issued Duncan a right to sue notice on April 17, 1998. Alleging sexual harassment and constructive discharge, Duncan filed suit against the College and GMC under both Title VII of the Civil Rights Act and the Missouri Human Rights Act. Duncan settled with the College prior to trial. After the jury found in Duncan's favor on both counts against GMC, GMC filed a post-trial motion for judgment as a matter of law or, alternatively, for a new trial. The district court denied the motion. The district court also awarded Duncan attorneys' fees in conjunction with GMC's post-trial motion. GMC appeals.

II.

A. Hostile Work Environment

GMC argues that it was entitled to judgment as a matter of law on Duncan's hostile work environment claim because she failed to prove a prima facie case. We agree....

It is undisputed that Duncan satisfies the first two elements of her prima facie case: she is a member of a protected group and Booth's attention was unwelcome. We also conclude that the harassment was based on sex....Although there is some evidence in the record that indicates some of Booth's behavior, and the resulting offensive and disagreeable atmosphere, was directed at both male and female employees, GMC points to ten incidents when Booth's behavior was directed at Duncan alone. GMC concedes that five of these ten incidents could arguably be based on sex: (1) Booth's proposition for a "relationship"; (2) Booth's touching of Duncan's hand; (3) Booth's request that Duncan sketch his planter; (4) the Man Hater's Club poster; and (5) Booth's request that Duncan type the He-Men Women Haters beliefs. "A plaintiff in this kind of case need not show...that only women were subjected to harassment, so long as she shows that women were the primary target of such harassment." We conclude that a jury could reasonably find that Duncan and her gender were the overriding themes of these incidents. The evidence is sufficient to support the jury finding that the harassment was based on sex.

We agree, however, with GMC's assertion that the alleged harassment was not so severe or pervasive as to alter a term, condition, or privilege of Duncan's employment....To clear the high threshold of actionable harm, Duncan has to show that "the workplace is permeated with discriminatory intimidation, ridicule, and insult." Harris v. Forklift Systems, Inc., 510 U.S. 17, 21, 126 L. Ed. 2d 295, 114 S. Ct. 367 (1993) (internal quotations omitted). "Conduct that is not severe or pervasive enough to create an objectively hostile or abusive work environment—an environment that a reasonable person would find hostile or abusive—is beyond Title VII's purview." Oncale, 523 U.S. at 81 (internal quotation omitted). Thus, the fourth part of a hostile environment claim includes both objective and subjective components: an environment that a reasonable person would find hostile and one that the victim actually perceived as abusive. Harris, 510 U.S. at 21-22. In determining whether the conduct is sufficiently severe or pervasive, we look to the totality of the circumstances, including the "frequency of the discriminatory conduct; its severity; whether it is physically threatening or humiliating, or a mere offensive utterance; and whether it unreasonably interferes with an employee's work performance."...These standards are designed to "filter out complaints attacking the ordinary tribulations of the workplace, such as the sporadic use of abusive language, gender-related jokes, and occasional teasing." Faragher v. City of Boca Raton, 524 U.S. 775, 788, 141 L. Ed. 2d 662, 118 S. Ct. 2275 (1998) (internal quotations omitted).

The evidence presented at trial illustrates that Duncan was upset and embarrassed by the posting of the derogatory poster and was disturbed by Booth's advances and his boorish behavior; but, as a matter of law, she has failed to show that these occurrences in the aggregate were so severe and extreme that a reasonable person would find that the terms or conditions of Duncan's employment had been altered....Numerous cases have rejected hostile work environment claims premised upon facts equally or more egregious than the conduct at issue here. See, e.g., Shepherd v. Comptroller of Pub. Accounts, 168 F.3d 871, 872, 874 (5th Cir.) (holding that several incidents over a two-year period, including the comment "your elbows are the same color as

your nipples," another comment that plaintiff had big thighs, repeated touching of plaintiff's arm, and attempts to look down the plaintiff's dress, were insufficient to support hostile work environment claim), cert. denied, 528 U.S. 963, 145 L. Ed. 2d 308, 120 S. Ct. 395 (1999); Adusumilli v. City of Chicago, 164 F.3d 353, 357, 361-62 (7th Cir. 1998) (holding conduct insufficient to support hostile environment claim when employee teased plaintiff, made sexual jokes aimed at her, told her not to wave at police officers "because people would think she was a prostitute," commented about low-necked tops, leered at her breasts, and touched her arm, fingers, or buttocks on four occasions), cert. denied, 528 U.S. 988, 145 L. Ed. 2d 367, 120 S. Ct. 450 (1999); Black v. Zaring Homes,, Inc., 104 F.3d 822, 823-24, 826 (6th Cir.) (reversing jury verdict and holding behavior merely offensive and insufficient to support hostile environment claim when employee reached across plaintiff, stating "nothing I like more in the morning than sticky buns" while staring at her suggestively; suggested to plaintiff that parcel of land be named "Hootersville," "Titsville," or "Twin Peaks"; and asked "weren't you there Saturday night dancing on the tables?" while discussing property near a biker bar), cert. denied, 522 U.S. 865, 139 L. Ed. 2d 114, 118 S. Ct. 172 (1997); Weiss v. Coca-Cola Bottling Co., 990 F.2d 333, 337 (7th Cir. 1993) (holding no sexual harassment when plaintiff's supervisor asked plaintiff for dates, asked about her personal life, called her a "dumb blond," put his hand on her shoulder several times, placed "I love you" signs at her work station, and attempted to kiss her twice at work and once in a bar).

Booth's actions were boorish, chauvinistic, and decidedly immature, but we cannot say they created an objectively hostile work environment permeated with sexual harassment. Construing the evidence in the light most favorable to Duncan, she presented evidence of four categories of harassing conduct based on her sex: a single request for a relationship, which was not repeated when she rebuffed it, four or five isolated incidents of Booth briefly touching her hand, a request to draw a planter, and teasing in the form of a poster and beliefs for an imaginary club. It is apparent that these incidents made Duncan uncomfortable, but they do not meet the standard necessary for actionable sexual harassment. It is worth noting that Duncan fails to even address this component of her prima facie case in her brief. We conclude as a matter of law that she did not show a sexually harassing hostile environment sufficiently severe or pervasive so as to alter the conditions of her employment, a failure that dooms Duncan's hostile work environment claim. See Meritor Sav. Bank, FSB v. Vinson, 477 U.S. 57, 67, 91 L. Ed. 2d 49, 106 S. Ct. 2399 (1986).

For the foregoing reasons, we reverse the district court's denial of judgment as a matter of law. Because GMC should have prevailed on its post-trial motion, the award of attorneys' fees is likewise vacated.

RICHARD S. ARNOLD, Circuit Judge, dissenting.

The Court concludes that the harassment suffered by Ms. Duncan was not so severe or pervasive as to alter a term, condition, or privilege of her employment, and that, therefore, GMC is entitled to judgment as a matter of law on her hostile-work environment and constructive-discharge claims. I respectfully disagree.

Ms. Duncan was subjected to a long series of incidents of sexual harassment in her workplace, going far beyond "gender-related jokes and occasional teasing." Faragher v. City of Boca Raton, 524 U.S. 775, 788 (1988). When the evidence is considered in the light most favorable to her, and she is given the benefit of all reasonable inferences, there is "substantial evidence to sustain the cause of action." Stockmen's Livestock Market, Inc. v. Norwest Bank of Sioux City, 135 F.3d 1236, 1240 (8th Cir. 1998) In Ms. Duncan's case, a jury reached the conclusion that Mr. Booth's offensive behavior created a hostile work environment. I believe this determination was reasonable and supported by ample evidence.

Ms. Duncan was subjected to a sexual advance by her supervisor within days of beginning her job. This proposition occurred during work hours and was a direct request for a sexual relationship. The Court characterizes this incident as a "single request," (but) [t]his description minimizes the effect of the sexual advance on Ms. Duncan's working conditions. During the months immediately following this incident, Mr. Booth became hostile to Ms. Duncan, increased his criticism of her work, and degraded her professional capabilities in front of her peers. Significantly, there is no suggestion that this hostile behavior occurred *before* Ms. Duncan refused his request for sex. From this evidence, a jury could easily draw the inference that Mr. Booth changed his attitude about Ms. Duncan's work because she rejected his sexual advance.

Further, this sexual overture was not an isolated incident. It was only the beginning of a string of degrading actions that Mr. Booth directed toward Ms. Duncan based on her sex. This inappropriate behavior took many forms, from physical touching to social humiliation to emotional intimidation. For example, Mr. Booth repeatedly touched Ms. Duncan inappropriately on her hand. He publicly singled her out before her colleagues as a "Man Hater" who "must always be in control of" sex. He required her to choose between drawing a vulgar planter displayed in his office or not being considered for a promotion, an unfair choice that would likely intimidate a reasonable person from seeking further career advancement.

The Court cites cases in which our sister Circuits have rejected hostile-work environment claims premised upon facts that the Court determines to be "equally or more egregious" than the conduct at issue here. I do not agree that Ms. Duncan experienced less severe harassment than those plaintiffs. For example, in Weiss v. Coca-Cola Bottling Co., 990 F.2d 333 (7th Cir. 1993), the

plaintiff did not allege that her work duties or evaluations were different because of her sex. This is not the situation Ms. Duncan faced. She was given specific tasks of a sexually charged nature, such as typing up the minutes of the "He-Man Women Hater's Club." Performing this "function" was presented to her as a required duty of her job.

Also Ms. Duncan was subjected to allegations that she was professionally "incompetent because of her sex."...She adduced evidence of this factor when she testified that after she rejected his sexual advance, Mr. Booth became more critical of her work. With the request for her to draw the planter for a promotion, Ms. Duncan also faced "conduct that would prevent her from succeeding in the workplace," a fact that Ms. Shepherd could not point to in her case. Additionally, Ms. Duncan was "propositioned" to sleep with her employer...a claim not made by Ms. Shepherd.

Finally, we note that in Ms. Duncan's case the harassing acts were directed specifically at her. The Court in Black v. Zaring Homes, 104 F.3d 822, 826 (6th Cir.), cert. denied, 522 U.S. 865, 139 L. Ed. 2d 114, 118 S. Ct. 172 (1997), stated that the lack of specific comments to the plaintiff supported the conclusion that the defendant's conduct was not severe enough to create actionable harm. By contrast, in the present case, a jury could reasonably conclude that Ms. Duncan felt particularly humiliated and degraded by Mr. Booth's behavior because she alone was singled out for this harassment.

Our own Court's Title VII jurisprudence suggests that Ms. Duncan experienced enough offensive conduct to constitute sexual harassment. For example, in Breeding v. Arthur J. Gallagher and Co. we reversed a grant of summary judgment to an employer, stating that a supervisor who "fondled his genitals [**25] in front of" a female employee and "used lewd and sexually inappropriate language" could create an environment severe enough to be actionable under Title VII. 164 F.3d 1151, 1159 (8th Cir. 1999). In Rorie v. United Parcel Service, we concluded that a work environment in which "a supervisor pats a female employee on the back, brushes up against her, and tells her she smells good" could be found by a jury to be a hostile work environment. 151 F.3d 757, 762 (8th Cir. 1998). Is it clear that the women in these cases suffered harassment greater than Ms. Duncan? I think not.

We have acknowledged that "there is no bright line between sexual harassment and merely unpleasant conduct, so a jury's decision must generally stand unless there is trial error." Hathaway v. Runyon, 132 F.3d 1214, 1221 (8th Cir. 1998). We have also ruled that "once there is evidence of improper conduct and subjective offense, the determination of whether the conduct rose to the level of abuse is largely in the hands of the jury." Howard v. Burns Bros., Inc., 149 F.3d 835, 840 (8th Cir. 1998). The Court admits that Ms. Duncan took subjective offense to Mr. Booth's behavior and characterizes Mr. Booth's behavior as "boorish, chauvinistic, and decidedly immature." Thus, the Court appears to agree that Mr. Booth's behavior was "improper conduct." I believe the Court errs in deciding as a matter of law that the jury did not act reasonably in concluding that Ms. Duncan faced severe or pervasive harassment that created a hostile work environment.

Therefore, I dissent from the Court's conclusion that Ms. Duncan did not present sufficient evidence to survive judgment as a matter of law on her hostile work-environment and constructive-discharge claims.

CASE QUESTIONS

1. Which opinion is more persuasive to you—the majority opinion or the dissenting opinion?
2. "Numerous cases have rejected hostile work environment claims premised upon facts equally or more egregious than the conduct at issue here." By what standard or criteria does the majority opinion conclude that Duncan's experiences were no worse than those mentioned in the other cases?
3. Should the majority on the appeals court substitute its judgment for that of the jury?

Age Discrimination: Burden of Persuasion

Gross v. FBL Financial Services, Inc.

557 U.S. ___ (2009)

JUSTICE CLARENCE THOMAS delivered the opinion of the court.

I

Petitioner Jack Gross began working for respondent FBL Financial Group, Inc. (FBL), in 1971. As of 2001, Gross held the position of claims administration director. But in 2003, when he was 54 years old, Gross was reassigned to the position of claims project coordinator. At that same time, FBL transferred many of Gross' job responsibilities to a newly created position—claims

administration manager. That position was given to Lisa Kneeskern, who had previously been supervised by Gross and who was then in her early forties. Although Gross (in his new position) and Kneeskern received the same compensation, Gross considered the reassignment a demotion because of FBL's reallocation of his former job responsibilities to Kneeskern.

In April 2004, Gross filed suit in District Court, alleging that his reassignment to the position of claims project coordinator violated the ADEA, which makes it unlawful for an employer to take adverse action against an employee "because of such individual's age." 29 U. S. C. §623(a). The case proceeded to trial, where Gross introduced evidence suggesting that his reassignment was based at least in part on his age. FBL defended its decision on the grounds that Gross' reassignment was part of a corporate restructuring and that Gross' new position was better suited to his skills.

At the close of trial, and over FBL's objections, the District Court instructed the jury that it must return a verdict for Gross if he proved, by a preponderance of the evidence, that FBL "demoted [him] to claims projec[t] coordinator" and that his "age was a motivating factor" in FBL's decision to demote him. The jury was further instructed that Gross' age would qualify as a "'motivating factor,' if [it] played a part or a role in [FBL]'s decision to demote [him]." The jury was also instructed regarding FBL's burden of proof. According to the District Court, the "verdict must be for [FBL]...if it has been proved by the preponderance of the evidence that [FBL] would have demoted [Gross] regardless of his age." *Ibid.* The jury returned a verdict for Gross, awarding him $46,945 in lost compensation. FBL challenged the jury instructions on appeal. The United States Court of Appeals for the Eighth Circuit reversed and remanded for a new trial, holding that the jury had been incorrectly instructed under the standard established in *Price Waterhouse* v. *Hopkins*, 490 U. S. 228 (1989). In *Price Waterhouse*, this Court addressed the proper allocation of the burden of persuasion in cases brought under Title VII of the Civil Rights Act of 1964, when an employee alleges that he suffered an adverse employment action because of both permissible and impermissible considerations—*i.e.*, a "mixed-motives" case. 490 U. S., at 232, 244–247 (plurality opinion). The *Price Waterhouse* decision was splintered. Four Justices joined a plurality opinion, and three Justices dissented. Six Justices ultimately agreed that if a Title VII plaintiff shows that discrimination was a "motivating" or a " 'substantial' " factor in the employer's action, the burden of persuasion should shift to the employer to show that it would have taken the same action regardless of that impermissible consideration. Justice O'Connor further found that to shift the burden of persuasion to the employer, the employee must present "direct evidence that an illegitimate criterion was a substantial factor in the [employment] decision."...

Because Gross conceded that he had not presented direct evidence of discrimination, the Court of Appeals held that the District Court should not have given the mixed-motives instruction. *Ibid.* Rather, Gross should have been held to the burden of persuasion applicable to typical, non-mixed-motives claims; the jury thus should have been instructed only to determine whether Gross had carried his burden of "prov[ing] that age was the determining factor in FBL's employment action."

We granted certiorari, 555 U.S. ___ (2008), and now vacate the decision of the Court of Appeals.

II

The parties have asked us to decide whether a plaintiff must "present direct evidence of discrimination in order to obtain a mixed-motive instruction in a non-Title VII discrimination case." Before reaching this question, however, we must first determine whether the burden of persuasion ever shifts to the party defending an alleged mixed-motives discrimination claim brought under the ADEA. We hold that it does not.

A

Petitioner relies on this Court's decisions construing Title VII for his interpretation of the ADEA. Because Title VII is materially different with respect to the relevant burden of persuasion, however, these decisions do not control our construction of the ADEA.

In *Price Waterhouse*, a plurality of the Court and two Justices concurring in the judgment determined that once a "plaintiff in a Title VII case proves that [the plaintiff's membership in a protected class] played a motivating part in an employment decision, the defendant may avoid a finding of liability only by proving by a preponderance of the evidence that it would have made the same decision even if it had not taken [that factor] into account." 490 U. S., at 258; see also *id.*, at 259–260 (opinion of White, J.); *id.*, at 276 (opinion of O'Connor, J.). But as we explained in *Desert Palace, Inc.* v. *Costa*, 539 U. S. 90, 94–95 (2003), Congress has since amended Title VII by explicitly authorizing discrimination claims in which an improper consideration was "a motivating factor" for an adverse employment decision. See 42 U. S. C. §2000e–2(m) (providing that "an unlawful employment practice is established when the complaining party demonstrates that race, color, religion, sex, or national origin was *a motivating factor* for any employment practice, even though other factors also motivated the practice" (emphasis added))...

This Court has never held that this burden-shifting framework applies to ADEA claims. And, we decline to do so now. When conducting statutory interpretation, we "must be careful not to apply rules applicable under one statute to a different statute without careful and critical examination." Unlike Title VII, the ADEA's text does not provide that a plaintiff may establish discrimination by showing that age was simply a motivating factor. Moreover, Congress neglected to add such a provision to the ADEA when it amended Title VII to add §§2000e–2(m) and 2000e–5(g)(2)(B), even though it contemporaneously amended the ADEA in several ways....

We cannot ignore Congress' decision to amend Title VII's relevant provisions but not make similar changes to the ADEA. When Congress amends one statutory provision but not another, it is presumed to have acted intentionally....As a result, the Court's interpretation of the ADEA is not governed by Title VII decisions such as *Desert Palace* and *Price Waterhouse*.

B

Our inquiry therefore must focus on the text of the ADEA to decide whether it authorizes a mixed-motives age discrimination claim. It does not. "Statutory construction must begin with the language employed by Congress and the assumption that the ordinary meaning of that language accurately expresses the legislative purpose."...The ADEA provides, in relevant part, that "[i]t shall be unlawful for an employer...to fail or refuse to hire or to discharge any individual or otherwise discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, *because of* such individual's age." 29 U. S. C. §623(a)(1) (emphasis added).

The words "because of" mean "by reason of: on account of." Webster's Third New International Dictionary 194 (1966); see also Oxford English Dictionary 746 (1933) (defining "because of" to mean "By reason *of*, on account *of*" (italics in original)); The Random House Dictionary of the English Language 132 (1966) (defining "because" to mean "by reason; on account"). Thus, the ordinary meaning of the ADEA's requirement that an employer took adverse action "because of" age is that age was the "reason" that the employer decided to act....To establish a disparate-treatment claim under the plain language of the ADEA, therefore, a plaintiff must prove that age was the "but-for" cause of the employer's adverse decision....

It follows, then, that under §623(a)(1), the plaintiff retains the burden of persuasion to establish that age was the "but-for" cause of the employer's adverse action. Indeed, we have previously held that the burden is allocated in this manner in ADEA cases. See *Kentucky Retirement Systems* v. *EEOC*, 554 U. S. ____. And nothing in the statute's text indicates that Congress has carved out an exception to that rule for a subset of ADEA cases. Where the statutory text is "silent on the allocation of the burden of persuasion," we "begin with the ordinary default rule that plaintiffs bear the risk of failing to prove their claims." *Schaffer* v. *Weast*, 546 U. S. 49, 56 (2005)...

Hence, the burden of persuasion necessary to establish employer liability is the same in alleged mixed-motives cases as in any other ADEA disparate-treatment action. A plaintiff must prove by a preponderance of the evidence (which may be direct or circumstantial), that age was the "but-for" cause of the challenged employer decision.

III

Finally, we reject petitioner's contention that our interpretation of the ADEA is controlled by *Price Waterhouse*, which initially established that the burden of persuasion shifted in alleged mixed-motives Title VII claims. In any event, it is far from clear that the Court would have the same approach were it to consider the question today in the first instance.

Whatever the deficiencies of *Price Waterhouse* in retrospect, it has become evident in the years since that case was decided that its burden-shifting framework is difficult to apply. For example, in cases tried to a jury, courts have found it particularly difficult to craft an instruction to explain its burden-shifting framework....Thus, even if *Price Waterhouse* was doctrinally sound, the problems associated with its application have eliminated any perceivable benefit to extending its framework to ADEA claims.

IV

We hold that a plaintiff bringing a disparate-treatment claim pursuant to the ADEA must prove, by a preponderance of the evidence, that age was the "but-for" cause of the challenged adverse employment action. The burden of persuasion does not shift to the employer to show that it would have taken the action regardless of age, even when a plaintiff has produced some evidence that age was one motivating factor in that decision. Accordingly, we vacate the judgment of the Court of Appeals and remand the case for further proceedings consistent with this opinion.

It is so ordered.

CASE QUESTIONS

1. What is the practical effect of this decision? Will plaintiffs with age-discrimination cases find it harder to win after *Gross*?
2. As Justice Thomas writes about it, does "but-for" cause here mean the "sole cause"? Must plaintiffs now eliminate any other possible cause in order to prevail in an ADEA lawsuit?
3. Based on this opinion, if the employer provides a nondiscriminatory reason for the change in the employee's status (such as "corporate restructuring" or "better alignment of skills"), does the employer bear any burden of showing that those are not just words but that, for example, the restructuring really does make sense or that the "skills" really do line up better in the new arrangement?
4. If the plaintiff was retained at the same salary as before, how could he have a "discrimination" complaint, since he still made the same amount of money?
5. The case was decided by a 5-4 majority. A dissent was filed by Justice Stevens, and a separate dissent by Justice Breyer, joined by Justices Ginsburg and Souter. You can access those at http://www.law.cornell.edu/supct/pdf/08-441P.ZD1.

Disability Discrimination

Toyota v. Williams

534 U.S. 184 (2000)

Factual Background

Ella Williams's job at the Toyota manufacturing plant involved using pneumatic tools. When her hands and arms began to hurt, she consulted a physician and was diagnosed with carpal tunnel syndrome. The doctor advised her not to work with any pneumatic tools or lift more than twenty pounds. Toyota shifted her to a different position in the quality control inspection operations (QCIO) department, where employees typically performed four different tasks. Initially, Williams was given two tasks, but Toyota changed its policy to require all QCIO employees to rotate through all four tasks. When she performed the "shell body audit," she had to hold her hands and arms up around shoulder height for several hours at a time.

She soon began to experience pain in her neck and shoulders. When she asked permission to do only the two tasks that she could perform without difficulty, she was refused. According to Toyota, Williams then began missing work regularly.

In 1997, Toyota Motor Manufacturing, Kentucky, Inc. terminated Ella Williams, citing her poor attendance record. Subsequently, claiming to be disabled from performing her automobile assembly line job by carpal tunnel syndrome and related impairments, Williams sued Toyota for failing to provide her with a reasonable accommodation as required by the Americans with Disabilities Act (ADA) of 1990.

Granting Toyota summary judgment, the district court held that Williams's impairment did not qualify as a disability under the ADA because it had not substantially limited any major life activity and that there was no evidence that Williams had had a record of a substantially limiting impairment. In reversing, the court of appeals found that the impairments substantially limited Williams in the major life activity of performing manual tasks. Because her ailments prevented her from doing the tasks associated with certain types of manual jobs that require the gripping of tools and repetitive work with hands and arms extended at or above shoulder levels for extended periods of time, the appellate court concluded that Williams demonstrated that her manual disability involved a class of manual activities affecting the ability to perform tasks at work.

JUSTICE SANDRA DAY O'CONNOR delivered the unanimous opinion of the court.

When it enacted the ADA in 1990, Congress found that some 43 million Americans have one or more physical or mental disabilities. If Congress intended everyone with a physical impairment that precluded the performance of some isolated, unimportant, or particularly difficult manual task to qualify as disabled, the number of disabled Americans would surely have been much higher. We therefore hold that to be substantially limited in performing manual tasks, an individual must have an impairment that prevents or severely restricts the individual from doing activities that are of central importance to most people's daily lives. The impairments impact must also be permanent or long-term.

When addressing the major life activity of performing manual tasks, the central inquiry must be whether the claimant is unable to

perform the variety of tasks central to most people's daily lives, not whether the claimant is unable to perform the tasks associated with her specific job. In this case, repetitive work with hands and arms extended at or above shoulder levels for extended periods of time is not an important part of most people's daily lives. The court, therefore, should not have considered respondent's inability to do such manual work in or specialized assembly line job as sufficient proof that she was substantially limited in performing manual tasks.

At the same time, the Court of Appeals appears to have disregarded the very type of evidence that it should have focused upon. It treated as irrelevant "[t]he fact that [respondent] can…ten[d] to her personal hygiene [and] carr[y]out personal or household chores." Yet household chores, bathing, and brushing one's teeth are among the types of manual tasks of central importance to people's daily lives, and should have been part of the assessment of whether respondent was substantially limited in performing manual tasks.

The District Court noted that at the time respondent sought an accommodation from petitioner, she admitted that she was able to do the manual tasks required by her original two jobs in QCIO. In addition, according to respondent's deposition testimony, even after her condition worsened, she could still brush her teeth, wash her face, bathe, tend her flower garden, fix breakfast, do laundry, and pick up around the house. The record also indicates that her medical conditions caused her to avoid sweeping, to quit dancing, to occasionally seek help dressing, and to reduce how often she plays with her children, gardens, and drives long distances. But these changes in her life did not amount to such severe restrictions in the activities that are of central importance to most people's daily lives that they establish a manual task disability as a matter of law. On this record, it was therefore inappropriate for the Court of Appeals to grant partial summary judgment to respondent on the issue of whether she was substantially limited in performing manual tasks, and its decision to do so must be reversed.

Accordingly, we reverse the Court of Appeals' judgment granting partial summary judgment to respondent and remand the case for further proceedings consistent with this opinion.

CASE QUESTIONS

1. What is the court's most important "finding of fact" relative to hands and arms? How does this relate to the statutory language that Congress created in the ADA?
2. The case is remanded to the lower courts "for further proceedings consistent with this opinion." In practical terms, what does that mean for this case?

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13.6.6: Summary and Exercises

Summary

For the past forty-eight 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?

SELF-TEST QUESTIONS

1. Affirmative action in employment a. is a requirement of Title VII of the Civil Rights Act of 1964
   b. is prohibited by Title VII of the Civil Rights Act of 1964
   c. is a federal statute enacted by Congress
   d. depends on the circumstances of each case for validity
2. The Age Discrimination in Employment Act protects a. all workers of any age
   b. all workers up to age seventy
   c. most workers over forty
   d. no workers over seventy
3. Federal laws barring discrimination against the handicapped and disabled a. apply to all disabilities
   b. apply to most disabilities in private employment
   c. apply to all disabilities in public employment
   d. apply to most disabilities in public employment
4. Under Title VII, a bona fide occupational qualification exception may never apply to cases involving a. racial discrimination
   b. religious discrimination
   c. sex discrimination
   d. age discrimination
5. The employment-at-will doctrine derives from a. Title VII of the Civil Rights Act of 1964
   b. employment contracts
   c. the common law
   d. liberty of contract under the Constitution

SELF-TEST AnswerS

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

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14.1: Chapter Introduction

Learning Objectives

After reading this chapter, you should understand the following:

1. How common-law employment at will is modified by common-law doctrine, federal statutes, and state statutes
2. Various kinds of prohibited discrimination under Title VII and examples of each kind
3. 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 the next 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. 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.

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14.2: Federal Employment Discrimination Laws

Learning Objectives

1. Know the various federal discrimination laws and how they are applied in various cases.
2. Distinguish between disparate impact and disparate treatment cases.
3. 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.

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 Young Americans for Freedom in the right wing of the GOP 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 200 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.See CongressLink, "Major Features of the Civil Rights Act of 1964," at http://www.congresslink.org/print_ba...ghts64text.htm.

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 30.1 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 (or gender) discrimination. *Barbano v. Madison County* (see Section 30.4.1 "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 "Introduction to Law and Legal Systems", Section 1.6 "A Sample Case"), 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 30.4.2 "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.

Sex discrimination in terms of wages and benefits is common enough that a number of sizeable class action lawsuits have been brought. A class action lawsuit is generally initiated by one or more people who believe that they, along with a group of other people, have been wronged in similar ways. Class actions for sexual harassment have been successful in the past. On June 11, 1998, the EEOC reached a $34 million settlement with Mitsubishi over allegations of widespread sexual harassment at the

Normal, Illinois, auto plant. The settlement involved about five hundred women who split the $34 million, although only seven received the maximum $300,000 allowed by law. The others received amounts ranging from $8,000 to $225,000.

Class action lawsuits involve specific plaintiffs (called class plaintiffs or class representatives) who are named in the class action lawsuit to assert the claims of the unnamed or absent members of the class; thus all those with a common complaint need not file their own separate lawsuit. From the point of view of plaintiffs who may have lost only a few thousand dollars annually as a result of the discrimination, a class action is advantageous: almost no lawyer would take a complicated civil case that had a potential gain of only a few thousand dollars. But if there are thousands of plaintiffs with very similar claims, the judgment could be well into the millions. Defendants can win the procedural battle by convincing a court that the proposed class of plaintiffs does not present common questions of law or of fact.

In the Wal-Mart class action case decided by the Supreme Court in 2011, three named plaintiffs (Dukes, Arana, and Kwapnoski) represented a proposed class of 1.5 million current or former Wal-Mart employees. The plaintiffs' attorneys asked the trial court in 2001 to certify as a class all women employed at any Wal-Mart domestic retail store at any time since December of 1998. As the case progressed through the judicial system, the class grew in size. If the class was certified, and discrimination proven, Wal-Mart could have been liable for over $1 billion in back pay. So Wal-Mart argued that as plaintiffs, the cases of the 1.5 million women did not present common questions of law or of fact—that is, that the claims were different enough that the Court should not allow a single class action lawsuit to present such differing kinds of claims. Initially, a federal judge disagreed, finding the class sufficiently coherent for purposes of federal civil procedure. The US Court of Appeals for the Ninth Circuit upheld the trial judge on two occasions.

But the US Supreme Court agreed with Wal-Mart. In the majority opinion, Justice Scalia discussed the commonality condition for class actions.

Quite obviously, the mere claim by employees of the same company that they have suffered a Title VII injury, or even a disparate impact Title VII injury, gives no cause to believe that all their claims can productively be litigated at once. Their claims must depend upon a common contention—for example, the assertion of discriminatory bias on the part of the same supervisor. That common contention, moreover, must be of such a nature that it is capable of classwide resolution—which means that determination of its truth or falsity will resolve an issue that is central to the validity of each one of the claims in one stroke.564 U.S. ___ (2011).

Finding that there was no common contention, the Supreme Court reversed the lower courts. Many commentators, and four dissenting Justices, believed that the majority opinion has created an unnecessarily high hurdle for class action plaintiffs in Title VII cases.

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. With regard to sex (gender), allowing women to be locker-room attendants only in a women's gym is a valid BFOQ. 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. With regard to national origin, directors of movies and theatrical productions would be within their Title VII BFOQ rights to restrict the roles of fictional Asians to those actors whose national origin was Asian, but could also permissibly hire Caucasian actors made up in "yellow face."

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 Raton*Faragher 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*,*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 30.4.3 "Age Discrimination: Burden of Persuasion") makes clear. It is now more difficult to prove an age discrimination claim than a claim under Title VII.

Disabilities: Discrimination against the Handicapped

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. (See Section 30.4.4 "Disability Discrimination".)

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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14.3: Employment at Will

Learning Objectives

1. Understand what is meant by employment at will under common law.
2. 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*,*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.) The court of appeals had reversed the trial court, and the Supreme Court had to decide if the professional code of Colorado accountants could be considered to be part of public policy. Given that accountants were licensed by the state on behalf of the public, and that the Board of Accountancy had published a code for accounting professionals and required an oath before licensing, the court noted the following:

The Colorado State Board of Accountancy is established pursuant to section 12-2-103, 5A C.R.S. (1991). The Board has responsibility for making appropriate rules of professional conduct, in order to establish and maintain a high standard of integrity in the profession of public accounting. § 12-2-104, 5A C.R.S. (1991). These rules of professional conduct govern every person practicing as a certified public accountant. Id. Failure to abide by these rules may result in professional discipline. § 12-2-123, 5A C.R.S. (1991). The rules of professional conduct for accountants have an important public purpose. They ensure the accurate reporting of financial information to the public. They allow the public and the business community to rely with confidence on financial reporting. Rule 7.1, 3 C.C.R. 705-1 (1991). In addition, they ensure that financial information will be reported consistently across many businesses. The legislature has endorsed these goals in section 12-2-101, 5A C.R.S.

The court went on to note that the stated purpose of the licensing and registration of certified public accountants was to “provide for the maintenance of high standards of professional conduct by those so licensed and registered as certified public accountants.” Further, the specific purpose of Rule 7.1 provided a clear mandate to support an action for wrongful discharge. Rule 7.1 is entitled “Integrity and Objectivity” and states, “A certificate holder shall not in the performance of professional services knowingly misrepresent facts, nor subordinate his judgment to others.” The fact that Mariani’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. This is not the majority view, as the case in Section 30.4.4 "Disability Discrimination" makes clear.

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 Compuserve, 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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14.4: Other Employment-Related Laws

Learning Objectives

1. 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 1988 estimate put the total held in pension funds at more than $1 *trillion*, costing the federal Treasury nearly $60 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. Multiemployer 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. 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 antidiscrimination 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." Two states and more than seventy counties or 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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14.5: Cases

Disparate Treatment: Burdens of Proof

Barbano v. Madison County

922 F.2d 139 (2d Cir. 1990)

Factual Background

At the Madison County (New York State) Veterans Service Agency, the position of director became vacant. The County Board of Supervisors created a committee of five men to hold interviews for the position. The committee interviewed Maureen E. Barbano and four others. When she entered the interview room, she heard someone say, “Oh, another woman.” At the beginning of the interview, Donald Greene said he would not consider “some woman” for the position. Greene also asked Barbano some personal questions about her family plans and whether her husband would mind if she transported male veterans. Ms. Barbano answered that the questions were irrelevant and discriminatory. However, Greene replied that the questions were relevant because he did not want to hire a woman who would get pregnant and quit. Another committee member, Newbold, agreed that the questions were relevant, and no committee member said the questions were not relevant.

None of the interviewers rebuked Greene or objected to the questions, and none of them told Barbano that she need not answer them. Barbano did state that if she decided to have a family she would take no more time off than medically necessary. Greene once again asked whether Barbano’s husband would object to her “running around the country with men” and said he would not want his wife to do it. Barbano said she was not his wife. The interview concluded after Barbano asked some questions about insurance.

After interviewing several other candidates, the board hired a man. Barbano sued the county for sex discrimination in violation of Title VII, and the district court held in her favor. She was awarded $55,000 in back pay, prejudgment interest, and attorney’s fees. Madison County appealed the judgment of Federal District Judge McAvoy; Barbano cross-appealed, asking for additional damages.

The court then found that Barbano had established a prima facie case of discrimination under Title VII, thus bringing into issue the appellants’ purported reasons for not hiring her. The appellants provided four reasons why they chose Wagner over Barbano, which the district court rejected either as unsupported by the record or as a pretext for discrimination in light of Barbano’s interview. The district court then found that because of Barbano’s education and experience in social services, the appellants had failed to prove that absent the discrimination, they still would not have hired Barbano. Accordingly, the court awarded Barbano back pay, prejudgment interest, and attorney’s fees. Subsequently, the court denied Barbano’s request for front pay and a mandatory injunction ordering her appointment as director upon the next vacancy. This appeal and cross-appeal followed.

From the Opinion of FEINBERG, CIRCUIT JUDGE

Appellants argue that the district court erred in finding that Greene’s statements during the interview showed that the Board discriminated in making the hiring decision, and that there was no direct evidence of discrimination by the Board, making it improper to require that appellants prove that they would not have hired Barbano absent the discrimination. Barbano in turn challenges the adequacy of the relief awarded to her by the district court.

A. Discrimination

At the outset, we note that Judge McAvoy’s opinion predated Price Waterhouse v. Hopkins, 490 U.S. 228, 109 S. Ct. 1775, 104 L. Ed. 2d 268 (1990), in which the Supreme Court made clear that a “pretext” case should be analyzed differently from a “mixed motives” case. *Id.* 109 S. Ct. at 1788-89. Judge McAvoy, not having the benefit of the Court’s opinion in Price Waterhouse, did not clearly distinguish between the two types of cases in analyzing the alleged discrimination. For purposes of this appeal, we do not think it is crucial how the district court categorized the case. Rather, we need only concern ourselves with whether the district

court's findings of fact are supported by the record and whether the district court applied the proper legal standards in light of its factual findings.

Whether the case is one of pretext or mixed motives, the plaintiff bears the burden of persuasion on the issue of whether gender played a part in the employment decision. *Price Waterhouse v. Hopkins, at 1788*. Appellants contend that Barbano did not sustain her burden of proving discrimination because the only evidence of discrimination involved Greene's statements during the interview, and Greene was an elected official over whom the other members of the Board exercised no control. Thus, appellants maintain, since the hiring decision was made by the 19-member board, evidence of discrimination by one member does not establish that the Board discriminated in making the hiring decision.

We agree that discrimination by one individual does not necessarily imply that a collective decision-making body of which the individual is a member also discriminated. However, the record before us supports the district court's finding that the Board discriminated in making the hiring decision.

First, there is little doubt that Greene's statements during the interview were discriminatory. He said he would not consider "some woman" for the position. His questioning Barbano about whether she would get pregnant and quit was also discriminatory, since it was unrelated to a bona fide occupational qualification. King v. Trans World Airlines, 738 F.2d 255, 258 n.2 (8th Cir. 1984). Similarly, Greene's questions about whether Barbano's husband would mind if she had to "run around the country with men," and that he would not want his wife to do it, were discriminatory, since once again the questions were unrelated to bona fide occupational qualifications. *Hopkins*, at 1786.

Moreover, the import of Greene's discriminatory questions was substantial, since apart from one question about her qualifications, none of the interviewers asked Barbano about other areas that allegedly formed the basis for selecting a candidate. Thus, Greene's questioning constituted virtually the entire interview, and so the district court properly found that the interview itself was discriminatory.

Next, given the discriminatory tenor of the interview, and the acquiescence of the other Committee members to Greene's line of questioning, it follows that the judge could find that those present at the interview, and not merely Greene, discriminated against Barbano. Judge McAvoy pointed out that the Chairman of the Committee, Newbold, thought Greene's discriminatory questions were relevant. Significantly, Barbano protested that Greene's questions were discriminatory, but no one agreed with her or told her that she need not answer. Indeed, no one even attempted to steer the interview in another direction. This knowing and informed toleration of discriminatory statements by those participating in the interview constitutes evidence of discrimination by all those present. That each member was independently elected to the Board does not mean that the Committee itself was unable to control the course of the interview. The Committee had a choice of how to conduct the interview, and the court could find that the Committee exercised that choice in a plainly discriminatory fashion.

This discrimination directly affected the hiring decision. At the end of the interviewing process, the interviewers evaluated the candidates, and on that basis submitted a recommendation as to which candidate to hire for the position. "Evaluation does not occur in a vacuum. By definition, when evaluating a candidate to fill a vacant position, one compares that candidate against other eligible candidates." Berl v. County of Westchester, 849 F.2d 712, 715 (2d Cir. 1988). Appellants stipulated that Barbano was qualified for the position. Again, because Judge McAvoy could find that the evaluation of Barbano was biased by gender discrimination, the judge could also find that the Committee's recommendation to hire Wagner, which was the result of a weighing of the relative merits of Barbano, Wagner and the other eligible candidates, was necessarily tainted by discrimination.

The Board in turn unanimously accepted the Committee's recommendation to hire Wagner, and so the Board's hiring decision was made in reliance upon a discriminatory recommendation. The Supreme Court in Hopkins v. Price Waterhouse found that a collective decision-making body can discriminate by relying upon discriminatory recommendations, and we are persuaded that the reasoning in that case applies here as well.

In Hopkins' case against Price Waterhouse, Ann Hopkins, a candidate for partnership at the accounting firm of Price Waterhouse, alleged that she was refused admission as a partner because of sex discrimination. Hopkins's evidence of discrimination consisted largely of evaluations made by various partners. Price Waterhouse argued that such evidence did not prove that its internal Policy Board, which was the effective decision-maker as to partnership in that case, had discriminated. The Court rejected that argument and found the evidence did establish discrimination:

Hopkins showed that the partnership solicited evaluations from all of the firm's partners; that it generally relied very heavily on such evaluations in making its decision; that some of the partners' comments were the product of [discrimination]; and that the firm in no way disclaimed reliance on those particular comments, either in Hopkins' case or in the past. Certainly, a plausible—and, one might say, inevitable—conclusion to draw from this set of circumstances is that the Policy Board in making its decision did

in fact take into account all of the partners' comments, including the comments that were motivated by [discrimination].

Hopkins, at 1794.

In a very significant sense, Barbano presents an even stronger case of discrimination because the only recommendation the Board relied upon here was discriminatory, whereas in Price Waterhouse, not all of the evaluations used in the decision-making process were discriminatory. On the other hand, it is true that the discriminatory content of some of the evaluations in Price Waterhouse was apparent from reading them, whereas here, the recommendation was embodied in a resolution to the Board and a reading of the resolution would not reveal that it was tainted by discrimination. Nonetheless, the facts in this case show that the Board was put on notice before making the appointment that the Committee's recommendation was biased by discrimination.

Barbano was a member of the public in attendance at the Board meeting in March 1980 when the Board voted to appoint Wagner. Before the Board adopted the resolution appointing Wagner, Barbano objected and asked the Board if male applicants were asked the questions she was asked during the interview. At this point, the entire Board membership was alerted to the possibility that the Committee had discriminated against Barbano during her interview. The Committee members did not answer the question, except for Newbold, who evaded the issue by stating that he did not ask such questions. The Board's ability to claim ignorance at this point was even further undermined by the fact that the Chairman of the Board, Callahan, was present at many of the interviews, including Barbano's, in his role as Chairman of the Board. Callahan did not refute Barbano's allegations, implying that they were worthy of credence, and none of the Board members even questioned Callahan on the matter.

It is clear that those present understood Barbano was alleging that she had been subjected to discrimination during her interview. John Patane, a member of the Board who had not interviewed Barbano, asked Barbano whether she was implying that Madison County was not an equal opportunity employer. Barbano said yes. Patane said the County already had their "token woman." Callahan apologized to Barbano for "any improper remarks that may have been made," but an apology for discrimination does not constitute an attempt to eliminate the discrimination from the hiring decision. Even though the Board was aware of possible improprieties, it made no investigation whatsoever into the allegations and did not disclaim any reliance upon the discrimination. In short, the circumstances show the Board was willing to rely on the Committee's recommendation even if Barbano had been discriminated against during her interview. On these facts, it was not clearly erroneous for the district court to conclude that Barbano sustained her burden of proving discrimination by the Board.

B. The Employer's Burden

Having found that Barbano carried her burden of proving discrimination, the district court then placed the burden on appellants to prove by a preponderance of the evidence that, absent the discrimination, they would not have hired Barbano for the position. Appellants argue that this burden is only placed on an employer if the plaintiff proves discrimination by direct evidence, and since Barbano's evidence of discrimination was merely circumstantial, the district court erred by placing the burden of proof on them. Appellants, however, misapprehend the nature of Barbano's proof and thus the governing legal standard.

The burden is properly placed on the defendant "once the plaintiff establishes by direct evidence that an illegitimate factor played a motivating or substantial role in an employment decision." Grant v. Hazelett Strip-Casting Corp., 880 F.2d 1564, 1568 (2d Cir. 1989). Thus, the key inquiry on this aspect of the case is whether the evidence is direct, that is, whether it shows that the impermissible criterion played some part in the decision-making process. See *Hopkins*, at 1791; *Grant*, 880 F.2d at 1569. If plaintiff provides such evidence, the fact-finder must then determine whether the evidence shows that the impermissible criterion played a motivating or substantial part in the hiring decision. Grant, 880 F.2d at 1569.

As we found above, the evidence shows that Barbano's gender was clearly a factor in the hiring decision. That the discrimination played a substantial role in that decision is shown by the importance of the recommendation to the Board. As Rafte testified, the Board utilizes a committee system, and so the Board "usually accepts" a committee's recommendation, as it did here when it unanimously voted to appoint Wagner. Had the Board distanced itself from Barbano's allegations of discrimination and attempted to ensure that it was not relying upon illegitimate criteria in adopting the Committee's recommendation, the evidence that discrimination played a substantial role in the Board's decision would be significantly weakened. The Board showed no inclination to take such actions, however, and in adopting the discriminatory recommendation allowed illegitimate criteria to play a substantial role in the hiring decision.

The district court thus properly required appellants to show that the Board would not have hired Barbano in the absence of discrimination. "The employer has not yet been shown to be a violator, but neither is it entitled to the...presumption of good faith concerning its employment decisions. At this point the employer may be required to convince the fact-finder that, despite the smoke, there is no fire." *Hopkins*, at 1798-99 (O'Connor, J., concurring).

Judge McAvoy noted in his opinion that appellants claimed they chose Wagner over Barbano because he was better qualified in the following areas: (1) interest in veterans' affairs; (2) experience in the military; (3) tactfulness; and (4) experience supervising an office. The judge found that the evidence before him supported only appellants' first and second reasons for refusing to hire Barbano, but acknowledged that the Committee members "were enamored with Wagner's military record and involvement with veterans' organizations." However, neither of these is listed as a job requirement in the job description, although the district court found that membership in a veterans' organization may indicate an interest in veterans' affairs. Nonetheless, the district court found that given Barbano's "education and experience in social services," appellants failed to carry their burden of proving by a preponderance of the evidence that, absent discrimination, they would not have hired Barbano.

The district court properly held appellants to a preponderance of the evidence standard. *Hopkins*, 109 S. Ct. at 1795....

At the time of the hiring decision in 1980, Barbano had been a Social Welfare Examiner for Madison County for the three previous years. In this position, she determined the eligibility of individuals for public assistance, medicaid or food stamps, and would then issue or deny the individual's application based on all federal, state and local regulations pertaining to the program from which the individual was seeking assistance. Barbano was thus familiar with the operation of public assistance programs, knew how to fill out forms relating to benefits and had become familiar with a number of welfare agencies that could be of use to veterans. Barbano was also working towards an Associate Degree in Human Services at the time. Rafte testified that Barbano's resume was "very impressive." Moreover, Barbano, unlike Wagner, was a resident of Madison County, and according to Rafte, a candidate's residency in the county was considered to be an advantage. Finally, Barbano had also enlisted in the United States Marine Corps in 1976, but during recruit training had been given a vaccine that affected her vision. She had received an honorable discharge shortly thereafter.

Wagner had nine years experience as an Air Force Personnel Supervisor, maintaining personnel records, had received a high school equivalency diploma and took several extension classes in management. He had been honorably discharged from the Air Force in 1965 with the rank of Staff Sergeant. Wagner was a member of the American Legion, and his application for the position included recommendations from two American Legion members. However, for the six years prior to his appointment as Director, Wagner's sole paid employment was as a school bus driver and part-time bartender at the American Legion. Wagner admitted that before he was hired he had no knowledge of federal, state and local laws, rules and regulations pertaining to veterans' benefits and services, or knowledge of the forms, methods and procedures used to process veteran benefits claims. Wagner also had not maintained liaison with welfare agencies and was unfamiliar with the various welfare agencies that existed in the county.

To be sure, both candidates were qualified for the Director's position, and it is not our job—nor was it the district court's—to decide which one was preferable. However, there is nothing to indicate that Judge McAvoy misconceived his function in this phase of the case, which was to decide whether appellants failed to prove by a preponderance of the evidence that they would not have hired Barbano even if they had not discriminated against her. The judge found that defendants had not met that burden. We must decide whether that finding was clearly erroneous, and we cannot say that it was.

CASE QUESTIONS

1. Madison County contended that Barbano needed to provide "direct evidence" of discrimination that had played a motivating or substantial part in the decision. What would such evidence look like? Is it likely that most plaintiffs who are discriminated against because of their gender would be able to get "direct evidence" that gender was a motivating or substantial factor?
2. The "clearly erroneous" standard is applied here, as it is in many cases where appellate courts review trial court determinations. State the test, and say why the appellate court believed that the trial judge's ruling was not "clearly erroneous."

Title VII and Hostile Work Environment

Duncan v. General Motors Corporation

300 F.3d 928 (8th Cir. 2002)

OPINION BY HANSEN, Circuit Judge.

The Junior College District of St. Louis (the College) arranged for Diana Duncan to provide in-house technical training at General Motors Corporation's (GMC) manufacturing facility in Wentzville, Missouri. Throughout her tenure at GMC, Duncan was subjected to unwelcome attention by a GMC employee, James Booth, which culminated in Duncan's resignation. Duncan subsequently filed

this suit under Title VII of the Civil Rights Act and the Missouri Human Rights Act, see 42 U.S.C. §§ 2000e-2000e-17; Mo. Rev. Stat. §§ 213.010-213.137,[2] alleging that she was sexually harassed and constructively discharged. A jury found in favor of Duncan and awarded her $4600 in back pay, $700,000 in emotional distress damages on her sexual harassment claim, and $300,000 in emotional distress damages on her constructive discharge claim. GMC appeals from the district court's denial of its post trial motion for judgment as a matter of law, and the district court's award of attorneys' fees attendant to the post trial motion. We reverse.

I.

Diana Duncan worked as a technical training clerk in the high-tech area at GMC as part of the College's Center for Business, Industry, and Labor program from August 1994 until May 1997. Duncan provided in-house training support to GMC employees.

Duncan first learned about the College's position at GMC from Booth, a United Auto Workers Union technology training coordinator for GMC. Booth frequented the country club where Duncan worked as a waitress and a bartender. Booth asked Duncan if she knew anyone who had computer and typing skills and who might be interested in a position at GMC. Duncan expressed interest in the job. Booth brought the pre-employment forms to Duncan at the country club, and he forwarded her completed forms to Jerry Reese, the manager of operations, manufacturing, and training for the College. Reese arranged to interview Duncan at GMC. Reese, Booth, and Ed Ish, who was Booth's management counterpart in the high-tech area of the GMC plant, participated in the interview. Duncan began work at GMC in August 1994.

Two weeks after Duncan began working at GMC, Booth requested an off-site meeting with her at a local restaurant. Booth explained to Duncan that he was in love with a married coworker and that his own marriage was troubled. Booth then propositioned Duncan by asking her if she would have a relationship with him. Duncan rebuffed his advance and left the restaurant. The next day Duncan mentioned the incident to the paint department supervisor Joe Rolen, who had no authority over Booth. Duncan did not report Booth's conduct to either Reese (her supervisor) at the College or Ish (Booth's management counterpart) at GMC. However, she did confront Booth, and he apologized for his behavior. He made no further such "propositions." Duncan stated that Booth's manner toward her after she declined his advance became hostile, and he became more critical of her work. For example, whenever she made a typographical error, he told her that she was incompetent and that he should hire a "Kelly Services" person to replace her. Duncan admitted that Booth's criticisms were often directed at other employees as well, including male coworkers.

Duncan testified to numerous incidents of Booth's inappropriate behavior. Booth directed Duncan to create a training document for him on his computer because it was the only computer with the necessary software. The screen saver that Booth had selected to use on his computer was a picture of a naked woman. Duncan testified to four or five occasions when Booth would unnecessarily touch her hand when she handed him the telephone. In addition, Booth had a planter in his office that was shaped like a slouched man wearing a sombrero. The planter had a hole in the front of the man's pants that allowed for a cactus to protrude. The planter was in plain view to anyone entering Booth's office. Booth also kept a child's pacifier that was shaped like a penis in his office that he occasionally showed to his coworkers and specifically to Duncan on two occasions.

In 1995, Duncan requested a pay increase and told Booth that she would like to be considered for an illustrator's position. Booth said that she would have to prove her artistic ability by drawing his planter. Duncan objected, particularly because previous applicants for the position were required to draw automotive parts and not his planter. Ultimately, Duncan learned that she was not qualified for the position because she did not possess a college degree.

Additionally in 1995, Booth and a College employee created a "recruitment" poster that was posted on a bulletin board in the high-tech area. The poster portrayed Duncan as the president and CEO of the Man Hater's Club of America. It listed the club's membership qualifications as: "Must always be in control of: (1) Checking, Savings, all loose change, etc.; (2) (Ugh) Sex; (3) Raising children our way!; (4) Men must always do household chores; (5) Consider T.V. Dinners a gourmet meal."...

On May 5, 1997, Booth asked Duncan to type a draft of the beliefs of the "He-Men Women Hater's Club." The beliefs included the following:

—Constitutional Amendment, the 19th, giving women [the] right to vote should be repealed. Real He-Men indulge in a lifestyle of cursing, using tools, handling guns, driving trucks, hunting and of course, drinking beer.

—Women really do have coodies [sic] and they can spread.

—Women [are] the cause of 99.9 per cent of stress in men.

—Sperm has a right to live.

—All great chiefs of the world are men.

—Prostitution should be legalized.

Duncan refused to type the beliefs and resigned two days later.

Duncan testified that she complained to anyone who would listen to her about Booth's behavior, beginning with paint department supervisor Joe Rolen after Booth propositioned her in 1994. Duncan testified that between 1994 and 1997 she complained several times to Reese at the College about Booth's behavior, which would improve at least in the short term after she spoke with Reese....

Duncan filed a charge of sex discrimination with the Equal Employment Opportunity Commission (EEOC) on October 30, 1997. The EEOC issued Duncan a right to sue notice on April 17, 1998. Alleging sexual harassment and constructive discharge, Duncan filed suit against the College and GMC under both Title VII of the Civil Rights Act and the Missouri Human Rights Act. Duncan settled with the College prior to trial. After the jury found in Duncan's favor on both counts against GMC, GMC filed a post-trial motion for judgment as a matter of law or, alternatively, for a new trial. The district court denied the motion. The district court also awarded Duncan attorneys' fees in conjunction with GMC's post-trial motion. GMC appeals.

II.

A. Hostile Work Environment

GMC argues that it was entitled to judgment as a matter of law on Duncan's hostile work environment claim because she failed to prove a prima facie case. We agree....

It is undisputed that Duncan satisfies the first two elements of her prima facie case: she is a member of a protected group and Booth's attention was unwelcome. We also conclude that the harassment was based on sex....Although there is some evidence in the record that indicates some of Booth's behavior, and the resulting offensive and disagreeable atmosphere, was directed at both male and female employees, GMC points to ten incidents when Booth's behavior was directed at Duncan alone. GMC concedes that five of these ten incidents could arguably be based on sex: (1) Booth's proposition for a "relationship"; (2) Booth's touching of Duncan's hand; (3) Booth's request that Duncan sketch his planter; (4) the Man Hater's Club poster; and (5) Booth's request that Duncan type the He-Men Women Haters beliefs. "A plaintiff in this kind of case need not show...that only women were subjected to harassment, so long as she shows that women were the primary target of such harassment." We conclude that a jury could reasonably find that Duncan and her gender were the overriding themes of these incidents. The evidence is sufficient to support the jury finding that the harassment was based on sex.

We agree, however, with GMC's assertion that the alleged harassment was not so severe or pervasive as to alter a term, condition, or privilege of Duncan's employment....To clear the high threshold of actionable harm, Duncan has to show that "the workplace is permeated with discriminatory intimidation, ridicule, and insult." Harris v. Forklift Systems, Inc., 510 U.S. 17, 21, 126 L. Ed. 2d 295, 114 S. Ct. 367 (1993) (internal quotations omitted). "Conduct that is not severe or pervasive enough to create an objectively hostile or abusive work environment—an environment that a reasonable person would find hostile or abusive—is beyond Title VII's purview." Oncale, 523 U.S. at 81 (internal quotation omitted). Thus, the fourth part of a hostile environment claim includes both objective and subjective components: an environment that a reasonable person would find hostile and one that the victim actually perceived as abusive. Harris, 510 U.S. at 21-22. In determining whether the conduct is sufficiently severe or pervasive, we look to the totality of the circumstances, including the "frequency of the discriminatory conduct; its severity; whether it is physically threatening or humiliating, or a mere offensive utterance; and whether it unreasonably interferes with an employee's work performance."...These standards are designed to "filter out complaints attacking the ordinary tribulations of the workplace, such as the sporadic use of abusive language, gender-related jokes, and occasional teasing." Faragher v. City of Boca Raton, 524 U.S. 775, 788, 141 L. Ed. 2d 662, 118 S. Ct. 2275 (1998) (internal quotations omitted).

The evidence presented at trial illustrates that Duncan was upset and embarrassed by the posting of the derogatory poster and was disturbed by Booth's advances and his boorish behavior; but, as a matter of law, she has failed to show that these occurrences in the aggregate were so severe and extreme that a reasonable person would find that the terms or conditions of Duncan's employment had been altered....Numerous cases have rejected hostile work environment claims premised upon facts equally or more egregious than the conduct at issue here. See, e.g., Shepherd v. Comptroller of Pub. Accounts, 168 F.3d 871, 872, 874 (5th Cir.) (holding that several incidents over a two-year period, including the comment "your elbows are the same color as

your nipples," another comment that plaintiff had big thighs, repeated touching of plaintiff's arm, and attempts to look down the plaintiff's dress, were insufficient to support hostile work environment claim), cert. denied, 528 U.S. 963, 145 L. Ed. 2d 308, 120 S. Ct. 395 (1999); Adusumilli v. City of Chicago, 164 F.3d 353, 357, 361-62 (7th Cir. 1998) (holding conduct insufficient to support hostile environment claim when employee teased plaintiff, made sexual jokes aimed at her, told her not to wave at police officers "because people would think she was a prostitute," commented about low-necked tops, leered at her breasts, and touched her arm, fingers, or buttocks on four occasions), cert. denied, 528 U.S. 988, 145 L. Ed. 2d 367, 120 S. Ct. 450 (1999); Black v. Zaring Homes,, Inc., 104 F.3d 822, 823-24, 826 (6th Cir.) (reversing jury verdict and holding behavior merely offensive and insufficient to support hostile environment claim when employee reached across plaintiff, stating "nothing I like more in the morning than sticky buns" while staring at her suggestively; suggested to plaintiff that parcel of land be named "Hootersville," "Titsville," or "Twin Peaks"; and asked "weren't you there Saturday night dancing on the tables?" while discussing property near a biker bar), cert. denied, 522 U.S. 865, 139 L. Ed. 2d 114, 118 S. Ct. 172 (1997); Weiss v. Coca-Cola Bottling Co., 990 F.2d 333, 337 (7th Cir. 1993) (holding no sexual harassment when plaintiff's supervisor asked plaintiff for dates, asked about her personal life, called her a "dumb blond," put his hand on her shoulder several times, placed "I love you" signs at her work station, and attempted to kiss her twice at work and once in a bar).

Booth's actions were boorish, chauvinistic, and decidedly immature, but we cannot say they created an objectively hostile work environment permeated with sexual harassment. Construing the evidence in the light most favorable to Duncan, she presented evidence of four categories of harassing conduct based on her sex: a single request for a relationship, which was not repeated when she rebuffed it, four or five isolated incidents of Booth briefly touching her hand, a request to draw a planter, and teasing in the form of a poster and beliefs for an imaginary club. It is apparent that these incidents made Duncan uncomfortable, but they do not meet the standard necessary for actionable sexual harassment. It is worth noting that Duncan fails to even address this component of her prima facie case in her brief. We conclude as a matter of law that she did not show a sexually harassing hostile environment sufficiently severe or pervasive so as to alter the conditions of her employment, a failure that dooms Duncan's hostile work environment claim. See Meritor Sav. Bank, FSB v. Vinson, 477 U.S. 57, 67, 91 L. Ed. 2d 49, 106 S. Ct. 2399 (1986).

For the foregoing reasons, we reverse the district court's denial of judgment as a matter of law. Because GMC should have prevailed on its post-trial motion, the award of attorneys' fees is likewise vacated.

RICHARD S. ARNOLD, Circuit Judge, dissenting.

The Court concludes that the harassment suffered by Ms. Duncan was not so severe or pervasive as to alter a term, condition, or privilege of her employment, and that, therefore, GMC is entitled to judgment as a matter of law on her hostile-work environment and constructive-discharge claims. I respectfully disagree.

Ms. Duncan was subjected to a long series of incidents of sexual harassment in her workplace, going far beyond "gender-related jokes and occasional teasing." Faragher v. City of Boca Raton, 524 U.S. 775, 788 (1988). When the evidence is considered in the light most favorable to her, and she is given the benefit of all reasonable inferences, there is "substantial evidence to sustain the cause of action." Stockmen's Livestock Market, Inc. v. Norwest Bank of Sioux City, 135 F.3d 1236, 1240 (8th Cir. 1998) In Ms. Duncan's case, a jury reached the conclusion that Mr. Booth's offensive behavior created a hostile work environment. I believe this determination was reasonable and supported by ample evidence.

Ms. Duncan was subjected to a sexual advance by her supervisor within days of beginning her job. This proposition occurred during work hours and was a direct request for a sexual relationship. The Court characterizes this incident as a "single request," (but) [t]his description minimizes the effect of the sexual advance on Ms. Duncan's working conditions. During the months immediately following this incident, Mr. Booth became hostile to Ms. Duncan, increased his criticism of her work, and degraded her professional capabilities in front of her peers. Significantly, there is no suggestion that this hostile behavior occurred *before* Ms. Duncan refused his request for sex. From this evidence, a jury could easily draw the inference that Mr. Booth changed his attitude about Ms. Duncan's work because she rejected his sexual advance.

Further, this sexual overture was not an isolated incident. It was only the beginning of a string of degrading actions that Mr. Booth directed toward Ms. Duncan based on her sex. This inappropriate behavior took many forms, from physical touching to social humiliation to emotional intimidation. For example, Mr. Booth repeatedly touched Ms. Duncan inappropriately on her hand. He publicly singled her out before her colleagues as a "Man Hater" who "must always be in control of" sex. He required her to choose between drawing a vulgar planter displayed in his office or not being considered for a promotion, an unfair choice that would likely intimidate a reasonable person from seeking further career advancement.

The Court cites cases in which our sister Circuits have rejected hostile-work environment claims premised upon facts that the Court determines to be "equally or more egregious" than the conduct at issue here. I do not agree that Ms. Duncan experienced less severe harassment than those plaintiffs. For example, in Weiss v. Coca-Cola Bottling Co., 990 F.2d 333 (7th Cir. 1993), the

plaintiff did not allege that her work duties or evaluations were different because of her sex. This is not the situation Ms. Duncan faced. She was given specific tasks of a sexually charged nature, such as typing up the minutes of the "He-Man Women Hater's Club." Performing this "function" was presented to her as a required duty of her job.

Also Ms. Duncan was subjected to allegations that she was professionally "incompetent because of her sex."...She adduced evidence of this factor when she testified that after she rejected his sexual advance, Mr. Booth became more critical of her work. With the request for her to draw the planter for a promotion, Ms. Duncan also faced "conduct that would prevent her from succeeding in the workplace," a fact that Ms. Shepherd could not point to in her case. Additionally, Ms. Duncan was "propositioned" to sleep with her employer...a claim not made by Ms. Shepherd.

Finally, we note that in Ms. Duncan's case the harassing acts were directed specifically at her. The Court in Black v. Zaring Homes, 104 F.3d 822, 826 (6th Cir.), cert. denied, 522 U.S. 865, 139 L. Ed. 2d 114, 118 S. Ct. 172 (1997), stated that the lack of specific comments to the plaintiff supported the conclusion that the defendant's conduct was not severe enough to create actionable harm. By contrast, in the present case, a jury could reasonably conclude that Ms. Duncan felt particularly humiliated and degraded by Mr. Booth's behavior because she alone was singled out for this harassment.

Our own Court's Title VII jurisprudence suggests that Ms. Duncan experienced enough offensive conduct to constitute sexual harassment. For example, in Breeding v. Arthur J. Gallagher and Co. we reversed a grant of summary judgment to an employer, stating that a supervisor who "fondled his genitals [**25] in front of" a female employee and "used lewd and sexually inappropriate language" could create an environment severe enough to be actionable under Title VII. 164 F.3d 1151, 1159 (8th Cir. 1999). In Rorie v. United Parcel Service, we concluded that a work environment in which "a supervisor pats a female employee on the back, brushes up against her, and tells her she smells good" could be found by a jury to be a hostile work environment. 151 F.3d 757, 762 (8th Cir. 1998). Is it clear that the women in these cases suffered harassment greater than Ms. Duncan? I think not.

We have acknowledged that "there is no bright line between sexual harassment and merely unpleasant conduct, so a jury's decision must generally stand unless there is trial error." Hathaway v. Runyon, 132 F.3d 1214, 1221 (8th Cir. 1998). We have also ruled that "once there is evidence of improper conduct and subjective offense, the determination of whether the conduct rose to the level of abuse is largely in the hands of the jury." Howard v. Burns Bros., Inc., 149 F.3d 835, 840 (8th Cir. 1998). The Court admits that Ms. Duncan took subjective offense to Mr. Booth's behavior and characterizes Mr. Booth's behavior as "boorish, chauvinistic, and decidedly immature." Thus, the Court appears to agree that Mr. Booth's behavior was "improper conduct." I believe the Court errs in deciding as a matter of law that the jury did not act reasonably in concluding that Ms. Duncan faced severe or pervasive harassment that created a hostile work environment.

Therefore, I dissent from the Court's conclusion that Ms. Duncan did not present sufficient evidence to survive judgment as a matter of law on her hostile work-environment and constructive-discharge claims.

CASE QUESTIONS

1. Which opinion is more persuasive to you—the majority opinion or the dissenting opinion?
2. "Numerous cases have rejected hostile work environment claims premised upon facts equally or more egregious than the conduct at issue here." By what standard or criteria does the majority opinion conclude that Duncan's experiences were no worse than those mentioned in the other cases?
3. Should the majority on the appeals court substitute its judgment for that of the jury?

Age Discrimination: Burden of Persuasion

Gross v. FBL Financial Services, Inc.

557 U.S. ___ (2009)

JUSTICE CLARENCE THOMAS delivered the opinion of the court.

I

Petitioner Jack Gross began working for respondent FBL Financial Group, Inc. (FBL), in 1971. As of 2001, Gross held the position of claims administration director. But in 2003, when he was 54 years old, Gross was reassigned to the position of claims project coordinator. At that same time, FBL transferred many of Gross' job responsibilities to a newly created position—claims

administration manager. That position was given to Lisa Kneeskern, who had previously been supervised by Gross and who was then in her early forties. Although Gross (in his new position) and Kneeskern received the same compensation, Gross considered the reassignment a demotion because of FBL's reallocation of his former job responsibilities to Kneeskern.

In April 2004, Gross filed suit in District Court, alleging that his reassignment to the position of claims project coordinator violated the ADEA, which makes it unlawful for an employer to take adverse action against an employee "because of such individual's age." 29 U. S. C. §623(a). The case proceeded to trial, where Gross introduced evidence suggesting that his reassignment was based at least in part on his age. FBL defended its decision on the grounds that Gross' reassignment was part of a corporate restructuring and that Gross' new position was better suited to his skills.

At the close of trial, and over FBL's objections, the District Court instructed the jury that it must return a verdict for Gross if he proved, by a preponderance of the evidence, that FBL "demoted [him] to claims projec[t] coordinator" and that his "age was a motivating factor" in FBL's decision to demote him. The jury was further instructed that Gross' age would qualify as a "'motivating factor,' if [it] played a part or a role in [FBL]'s decision to demote [him]." The jury was also instructed regarding FBL's burden of proof. According to the District Court, the "verdict must be for [FBL]...if it has been proved by the preponderance of the evidence that [FBL] would have demoted [Gross] regardless of his age." *Ibid.* The jury returned a verdict for Gross, awarding him $46,945 in lost compensation. FBL challenged the jury instructions on appeal. The United States Court of Appeals for the Eighth Circuit reversed and remanded for a new trial, holding that the jury had been incorrectly instructed under the standard established in *Price Waterhouse* v. *Hopkins*, 490 U. S. 228 (1989). In *Price Waterhouse*, this Court addressed the proper allocation of the burden of persuasion in cases brought under Title VII of the Civil Rights Act of 1964, when an employee alleges that he suffered an adverse employment action because of both permissible and impermissible considerations—*i.e.*, a "mixed-motives" case. 490 U. S., at 232, 244–247 (plurality opinion). The *Price Waterhouse* decision was splintered. Four Justices joined a plurality opinion, and three Justices dissented. Six Justices ultimately agreed that if a Title VII plaintiff shows that discrimination was a "motivating" or a " 'substantial' " factor in the employer's action, the burden of persuasion should shift to the employer to show that it would have taken the same action regardless of that impermissible consideration. Justice O'Connor further found that to shift the burden of persuasion to the employer, the employee must present "direct evidence that an illegitimate criterion was a substantial factor in the [employment] decision."...

Because Gross conceded that he had not presented direct evidence of discrimination, the Court of Appeals held that the District Court should not have given the mixed-motives instruction. *Ibid.* Rather, Gross should have been held to the burden of persuasion applicable to typical, non-mixed-motives claims; the jury thus should have been instructed only to determine whether Gross had carried his burden of "prov[ing] that age was the determining factor in FBL's employment action."

We granted certiorari, 555 U.S. ___ (2008), and now vacate the decision of the Court of Appeals.

II

The parties have asked us to decide whether a plaintiff must "present direct evidence of discrimination in order to obtain a mixed-motive instruction in a non-Title VII discrimination case." Before reaching this question, however, we must first determine whether the burden of persuasion ever shifts to the party defending an alleged mixed-motives discrimination claim brought under the ADEA. We hold that it does not.

A

Petitioner relies on this Court's decisions construing Title VII for his interpretation of the ADEA. Because Title VII is materially different with respect to the relevant burden of persuasion, however, these decisions do not control our construction of the ADEA.

In *Price Waterhouse*, a plurality of the Court and two Justices concurring in the judgment determined that once a "plaintiff in a Title VII case proves that [the plaintiff's membership in a protected class] played a motivating part in an employment decision, the defendant may avoid a finding of liability only by proving by a preponderance of the evidence that it would have made the same decision even if it had not taken [that factor] into account." 490 U. S., at 258; see also *id.*, at 259–260 (opinion of White, J.); *id.*, at 276 (opinion of O'Connor, J.). But as we explained in *Desert Palace, Inc.* v. *Costa*, 539 U. S. 90, 94–95 (2003), Congress has since amended Title VII by explicitly authorizing discrimination claims in which an improper consideration was "a motivating factor" for an adverse employment decision. See 42 U. S. C. §2000e–2(m) (providing that "an unlawful employment practice is established when the complaining party demonstrates that race, color, religion, sex, or national origin was *a motivating factor* for any employment practice, even though other factors also motivated the practice" (emphasis added))...

This Court has never held that this burden-shifting framework applies to ADEA claims. And, we decline to do so now. When conducting statutory interpretation, we "must be careful not to apply rules applicable under one statute to a different statute without careful and critical examination." Unlike Title VII, the ADEA's text does not provide that a plaintiff may establish discrimination by showing that age was simply a motivating factor. Moreover, Congress neglected to add such a provision to the ADEA when it amended Title VII to add §§2000e–2(m) and 2000e–5(g)(2)(B), even though it contemporaneously amended the ADEA in several ways....

We cannot ignore Congress' decision to amend Title VII's relevant provisions but not make similar changes to the ADEA. When Congress amends one statutory provision but not another, it is presumed to have acted intentionally....As a result, the Court's interpretation of the ADEA is not governed by Title VII decisions such as *Desert Palace* and *Price Waterhouse*.

B

Our inquiry therefore must focus on the text of the ADEA to decide whether it authorizes a mixed-motives age discrimination claim. It does not. "Statutory construction must begin with the language employed by Congress and the assumption that the ordinary meaning of that language accurately expresses the legislative purpose."...The ADEA provides, in relevant part, that "[i]t shall be unlawful for an employer...to fail or refuse to hire or to discharge any individual or otherwise discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, *because of* such individual's age." 29 U. S. C. §623(a)(1) (emphasis added).

The words "because of" mean "by reason of: on account of." Webster's Third New International Dictionary 194 (1966); see also Oxford English Dictionary 746 (1933) (defining "because of" to mean "By reason *of*, on account *of*" (italics in original)); The Random House Dictionary of the English Language 132 (1966) (defining "because" to mean "by reason; on account"). Thus, the ordinary meaning of the ADEA's requirement that an employer took adverse action "because of" age is that age was the "reason" that the employer decided to act....To establish a disparate-treatment claim under the plain language of the ADEA, therefore, a plaintiff must prove that age was the "but-for" cause of the employer's adverse decision....

It follows, then, that under §623(a)(1), the plaintiff retains the burden of persuasion to establish that age was the "but-for" cause of the employer's adverse action. Indeed, we have previously held that the burden is allocated in this manner in ADEA cases. See *Kentucky Retirement Systems* v. *EEOC*, 554 U. S. ____. And nothing in the statute's text indicates that Congress has carved out an exception to that rule for a subset of ADEA cases. Where the statutory text is "silent on the allocation of the burden of persuasion," we "begin with the ordinary default rule that plaintiffs bear the risk of failing to prove their claims." *Schaffer* v. *Weast*, 546 U. S. 49, 56 (2005)...

Hence, the burden of persuasion necessary to establish employer liability is the same in alleged mixed-motives cases as in any other ADEA disparate-treatment action. A plaintiff must prove by a preponderance of the evidence (which may be direct or circumstantial), that age was the "but-for" cause of the challenged employer decision.

III

Finally, we reject petitioner's contention that our interpretation of the ADEA is controlled by *Price Waterhouse*, which initially established that the burden of persuasion shifted in alleged mixed-motives Title VII claims. In any event, it is far from clear that the Court would have the same approach were it to consider the question today in the first instance.

Whatever the deficiencies of *Price Waterhouse* in retrospect, it has become evident in the years since that case was decided that its burden-shifting framework is difficult to apply. For example, in cases tried to a jury, courts have found it particularly difficult to craft an instruction to explain its burden-shifting framework....Thus, even if *Price Waterhouse* was doctrinally sound, the problems associated with its application have eliminated any perceivable benefit to extending its framework to ADEA claims.

IV

We hold that a plaintiff bringing a disparate-treatment claim pursuant to the ADEA must prove, by a preponderance of the evidence, that age was the "but-for" cause of the challenged adverse employment action. The burden of persuasion does not shift to the employer to show that it would have taken the action regardless of age, even when a plaintiff has produced some evidence that age was one motivating factor in that decision. Accordingly, we vacate the judgment of the Court of Appeals and remand the case for further proceedings consistent with this opinion.

It is so ordered.

CASE QUESTIONS

1. What is the practical effect of this decision? Will plaintiffs with age-discrimination cases find it harder to win after *Gross*?
2. As Justice Thomas writes about it, does "but-for" cause here mean the "sole cause"? Must plaintiffs now eliminate any other possible cause in order to prevail in an ADEA lawsuit?
3. Based on this opinion, if the employer provides a nondiscriminatory reason for the change in the employee's status (such as "corporate restructuring" or "better alignment of skills"), does the employer bear any burden of showing that those are not just words but that, for example, the restructuring really does make sense or that the "skills" really do line up better in the new arrangement?
4. If the plaintiff was retained at the same salary as before, how could he have a "discrimination" complaint, since he still made the same amount of money?
5. The case was decided by a 5-4 majority. A dissent was filed by Justice Stevens, and a separate dissent by Justice Breyer, joined by Justices Ginsburg and Souter. You can access those at http://www.law.cornell.edu/supct/pdf/08-441P.ZD1.

Disability Discrimination

Toyota v. Williams

534 U.S. 184 (2000)

Factual Background

Ella Williams's job at the Toyota manufacturing plant involved using pneumatic tools. When her hands and arms began to hurt, she consulted a physician and was diagnosed with carpal tunnel syndrome. The doctor advised her not to work with any pneumatic tools or lift more than twenty pounds. Toyota shifted her to a different position in the quality control inspection operations (QCIO) department, where employees typically performed four different tasks. Initially, Williams was given two tasks, but Toyota changed its policy to require all QCIO employees to rotate through all four tasks. When she performed the "shell body audit," she had to hold her hands and arms up around shoulder height for several hours at a time.

She soon began to experience pain in her neck and shoulders. When she asked permission to do only the two tasks that she could perform without difficulty, she was refused. According to Toyota, Williams then began missing work regularly.

In 1997, Toyota Motor Manufacturing, Kentucky, Inc. terminated Ella Williams, citing her poor attendance record. Subsequently, claiming to be disabled from performing her automobile assembly line job by carpal tunnel syndrome and related impairments, Williams sued Toyota for failing to provide her with a reasonable accommodation as required by the Americans with Disabilities Act (ADA) of 1990.

Granting Toyota summary judgment, the district court held that Williams's impairment did not qualify as a disability under the ADA because it had not substantially limited any major life activity and that there was no evidence that Williams had had a record of a substantially limiting impairment. In reversing, the court of appeals found that the impairments substantially limited Williams in the major life activity of performing manual tasks. Because her ailments prevented her from doing the tasks associated with certain types of manual jobs that require the gripping of tools and repetitive work with hands and arms extended at or above shoulder levels for extended periods of time, the appellate court concluded that Williams demonstrated that her manual disability involved a class of manual activities affecting the ability to perform tasks at work.

JUSTICE SANDRA DAY O'CONNOR delivered the unanimous opinion of the court.

When it enacted the ADA in 1990, Congress found that some 43 million Americans have one or more physical or mental disabilities. If Congress intended everyone with a physical impairment that precluded the performance of some isolated, unimportant, or particularly difficult manual task to qualify as disabled, the number of disabled Americans would surely have been much higher. We therefore hold that to be substantially limited in performing manual tasks, an individual must have an impairment that prevents or severely restricts the individual from doing activities that are of central importance to most people's daily lives. The impairments impact must also be permanent or long-term.

When addressing the major life activity of performing manual tasks, the central inquiry must be whether the claimant is unable to

perform the variety of tasks central to most people's daily lives, not whether the claimant is unable to perform the tasks associated with her specific job. In this case, repetitive work with hands and arms extended at or above shoulder levels for extended periods of time is not an important part of most people's daily lives. The court, therefore, should not have considered respondent's inability to do such manual work in or specialized assembly line job as sufficient proof that she was substantially limited in performing manual tasks.

At the same time, the Court of Appeals appears to have disregarded the very type of evidence that it should have focused upon. It treated as irrelevant "[t]he fact that [respondent] can…ten[d] to her personal hygiene [and] carr[y]out personal or household chores." Yet household chores, bathing, and brushing one's teeth are among the types of manual tasks of central importance to people's daily lives, and should have been part of the assessment of whether respondent was substantially limited in performing manual tasks.

The District Court noted that at the time respondent sought an accommodation from petitioner, she admitted that she was able to do the manual tasks required by her original two jobs in QCIO. In addition, according to respondent's deposition testimony, even after her condition worsened, she could still brush her teeth, wash her face, bathe, tend her flower garden, fix breakfast, do laundry, and pick up around the house. The record also indicates that her medical conditions caused her to avoid sweeping, to quit dancing, to occasionally seek help dressing, and to reduce how often she plays with her children, gardens, and drives long distances. But these changes in her life did not amount to such severe restrictions in the activities that are of central importance to most people's daily lives that they establish a manual task disability as a matter of law. On this record, it was therefore inappropriate for the Court of Appeals to grant partial summary judgment to respondent on the issue of whether she was substantially limited in performing manual tasks, and its decision to do so must be reversed.

Accordingly, we reverse the Court of Appeals' judgment granting partial summary judgment to respondent and remand the case for further proceedings consistent with this opinion.

CASE QUESTIONS

1. What is the court's most important "finding of fact" relative to hands and arms? How does this relate to the statutory language that Congress created in the ADA?
2. The case is remanded to the lower courts "for further proceedings consistent with this opinion." In practical terms, what does that mean for this case?

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14.6: Summary and Exercises

Summary

For the past forty-eight 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?

SELF-TEST QUESTIONS

1. Affirmative action in employment a. is a requirement of Title VII of the Civil Rights Act of 1964
   b. is prohibited by Title VII of the Civil Rights Act of 1964
   c. is a federal statute enacted by Congress
   d. depends on the circumstances of each case for validity
2. The Age Discrimination in Employment Act protects a. all workers of any age
   b. all workers up to age seventy
   c. most workers over forty
   d. no workers over seventy
3. Federal laws barring discrimination against the handicapped and disabled a. apply to all disabilities
   b. apply to most disabilities in private employment
   c. apply to all disabilities in public employment
   d. apply to most disabilities in public employment
4. Under Title VII, a bona fide occupational qualification exception may never apply to cases involving a. racial discrimination
   b. religious discrimination
   c. sex discrimination
   d. age discrimination
5. The employment-at-will doctrine derives from a. Title VII of the Civil Rights Act of 1964
   b. employment contracts
   c. the common law
   d. liberty of contract under the Constitution

SELF-TEST AnswerS

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

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14.7: BANKRUPTCY

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14.7.1: Chapter Introduction

Learning Objectives

After reading this chapter, you should understand the following:

1. A short history of US bankruptcy law
2. An overview of key provisions of the 2005 bankruptcy act
3. The basic operation of Chapter 7 bankruptcy
4. The basic operation of Chapter 11 bankruptcy
5. The basic operation of Chapter 13 bankruptcy
6. What debtor's relief is available outside of bankruptcy

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14.7.2: Introductin to Bankruptcy and Overview of the 2005 Bankruptcy Act

Learning Objectives

1. Understand what law governs bankruptcy in the United States.
2. 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.

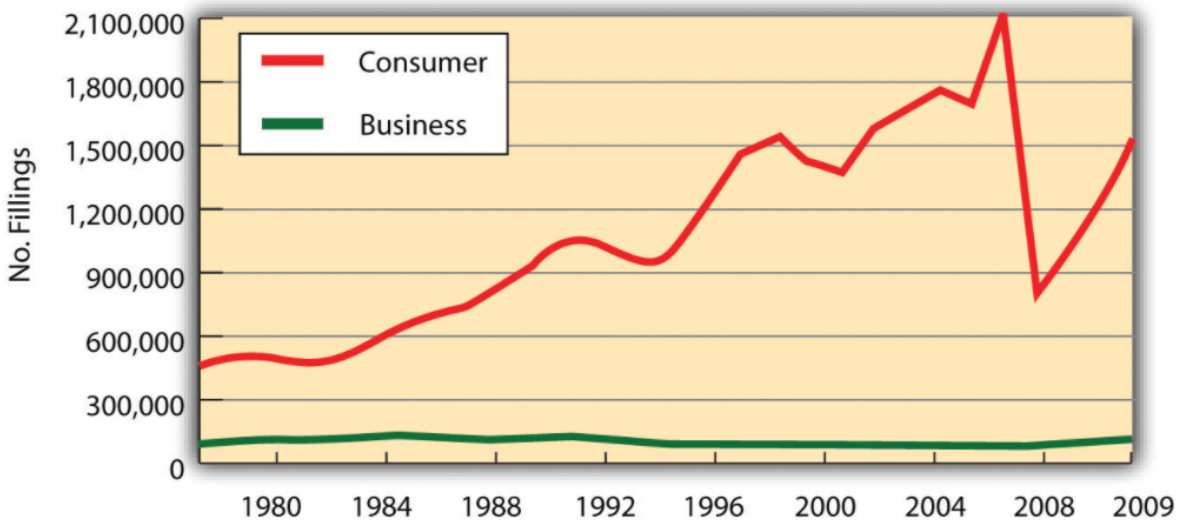
Bankruptcy Statutes

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 35.1 "US Bankruptcies, 1980–2009"). 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, http://www.cch.com/bankruptcy/bankruptcy_04-21.pdf.—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 35.1 US Bankruptcies, 1980–2009



Bankruptcy Action.com, www.bankruptcyaction.com/USbankstats.htm, statistics from Administrative Office of the Courts.

Bankruptcy Courts, Judges, and Costs

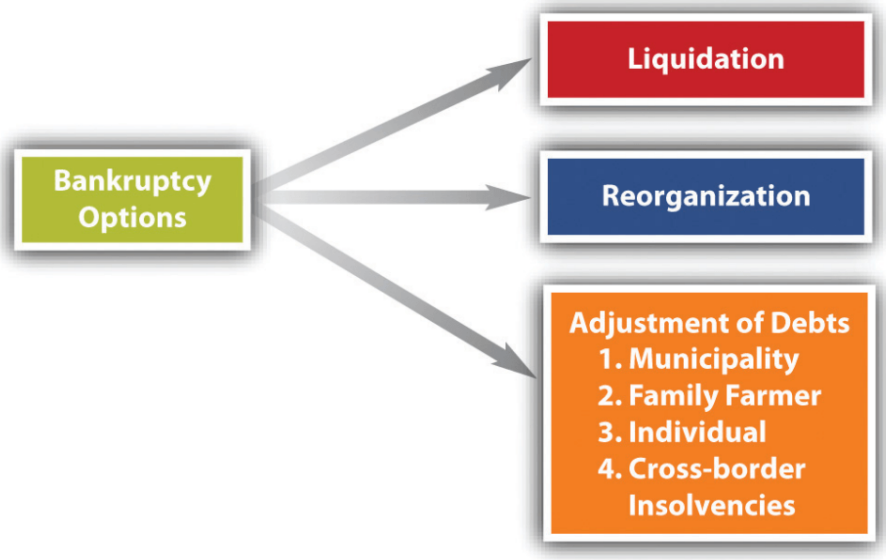
Each federal judicial district has a US Bankruptcy Court, whose judges are appointed by US Courts of Appeal. Unless both sides agree otherwise, bankruptcy judges are to hear only bankruptcy matters (called core proceedings). Bankruptcy trustees are government lawyers appointed by the US Attorney General. They have administrative responsibilities in overseeing the proceedings.

The filing fee for a bankruptcy is about $200, depending upon the type of bankruptcy, and the typical lawyer's fee for uncomplicated cases is about $1,200–$1,400.

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 35.2 "Bankruptcy Options").

Figure 35.2 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:

- 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 35.5 "Alternatives to Bankruptcy", "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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14.7.3: Case Administration; Creditors' Claims; Debtors' Exemptions and Dischargeable Debts; Debtor's Estate

Learning Objectives

1. Understand the basic procedures involved in administering a bankruptcy case.
2. Recognize the basic elements of creditors' rights under the bankruptcy code.
3. Understand the fundamentals of what property is included in the debtor's estate.
4. Identify some of the debtor's exemptions—what property can be kept by the debtor.
5. Know some of the debts that cannot be discharged in bankruptcy.
6. 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. To put anyone into bankruptcy involuntarily, the petitioning creditors must meet three conditions: (1) they must have claims for unsecured debt amounting to at least $13,475; (2) three creditors must join in the petition whenever twelve or more creditors have claims against the particular debtor—otherwise, one creditor may file an involuntary petition, as long as his claim is for at least $13,475; (3) there must be no bona fide dispute about the debt owing. If there is a dispute, the debtor can resist the involuntary filing, and if she wins the dispute, the creditors who pushed for the involuntary petition have to pay the associated costs. Persons owing less than $13,475, farmers, and charitable organizations cannot be forced into bankruptcy.

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 35.3 "Chapter 7 Liquidation".

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 (as discussed in Chapter 33 "Secured Transactions and Suretyship" and Chapter 34 "Mortgages and Nonconsensual Liens"). 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 35.3 "Distribution of the Estate"), 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 35.3 "Chapter 7 Liquidation".

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 35.6 "Cases", *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 35.3 "Chapter 7 Liquidation", 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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14.7.4: Chapter 7 Liquidation

Learning Objectives

1. Recognize the grounds for a Chapter 7 case to be dismissed.
2. Be familiar with the BAPCPA's means-testing requirements before Chapter 7 discharge is granted.
3. Know under what circumstances a debtor will be denied discharge.
4. 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.

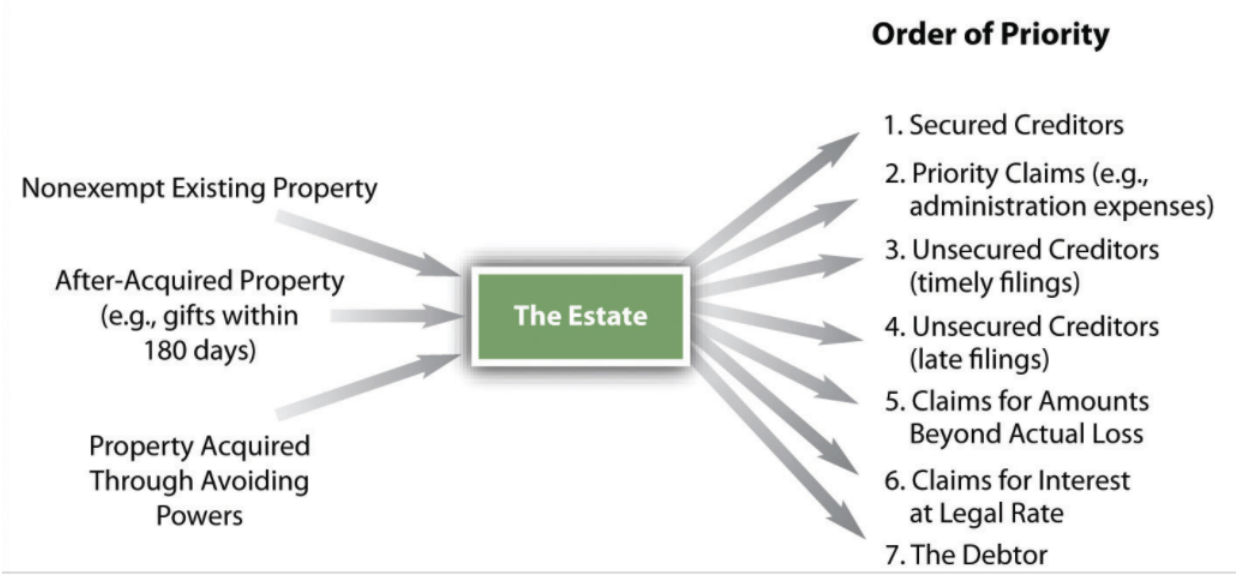
Distribution of the Estate and Discharge; Denying Discharge

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/...10th/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 35.3 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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14.7.5: Chapter 11 and Chapter 13 Bankruptcies

Learning Objectives

1. Understand the basic concepts of Chapter 11 bankruptcies.
2. 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 35.2 "Case Administration; Creditors' Claims; Debtors' Exemptions and Dischargeable Debts; Debtor's Estate", 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 $336,000, and secured debts of less than $1,010,650 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 35.6 "Cases", *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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14.7.6: Alternatives to Bankruptcy

Learning Objectives

1. 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.
2. 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

Assignment for 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

A **composition** 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, composition 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 composition lies in the creditors' agreement: an assignment implies no agreement among the creditors, whereas a composition does. Not all creditors of the particular debtor need agree to the composition for it to be valid. A creditor who does not agree to the composition 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 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 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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14.7.7: Cases

Dischargeability of Student Loans under Chapter 7

In re Zygarewicz

423 B.R. 909 (Bkrtcy.E.D.Cal. 2010)

MCMANUS, BANKRUPTCY JUDGE.

Angela Zygarewicz, a chapter 7 debtor and the plaintiff in this adversary proceeding, borrowed 16 government-guaranteed student [sic] loans totaling $81,429. The loans have been assigned to Educational Credit Management Corporation ("ECMC"). By September 2009, the accrual of interest on these student loans had caused the debt to balloon to more than $146,000. The debtor asks the court to declare that these student loans were discharged in bankruptcy.

The Bankruptcy Code provides financially distressed debtors with a fresh start by discharging most of their pre-petition debts....However, under 11 U.S.C. § 523(a)(8), there is a presumption that educational loans extended by or with the aid of a governmental unit or nonprofit institution are nondischargeable unless the debtor can demonstrate that their repayment would be an undue hardship. See [Citation]. This exception to a bankruptcy discharge ensures that student loans, which are typically extended solely on the basis of the student's future earnings potential, cannot be discharged by recent graduates who then pocket all of the future benefits derived from their education. See [Citation].

The debtor bears the burden of proving by a preponderance of the evidence that she is entitled to a discharge of the student loan. See [Citation]. That is, the debtor must prove that repayment of student loans will cause an undue hardship.

The Bankruptcy Code does not define "the undue hardship." Courts interpreting section 523(a)(8), however, have concluded that undue hardship [and] is something more than "garden-variety hardship." [Citation.] Only cases involving "real and substantial" hardship merit discharges. See [Citation.]

The Ninth Circuit has adopted a three-part test to guide courts in their attempts to determine whether a debtor will suffer an undue hardship is required to repay a student loan:

- First, the debtor must establish "that she cannot maintain, based on current income and expenses, a 'minimal' standard of living for herself and her dependents if forced to repay the loans."...
- Second, the debtor must show "that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans."...
- The third prong requires "that the debtor has made good faith efforts to repay the loans...."

(*Pena,* citing *Brunner v. N.Y. State Higher Educ. Servs. Corp*., [Citation]).

Debtor must satisfy all three parts of the *Brunner* test before her student loans can be discharged. Failure to prove any of the three prongs will defeat a debtor's case.

When this bankruptcy case was filed in September 2005, the debtor was a single woman and had no dependents. She is 39 years old.

Schedule I reported that the debtor was unemployed. The debtor's responses to the Statement of Financial Affairs revealed that she had received $5,500 in income during 2005 prior to the filing of the petition. Evidence at trial indicated that after the petition was filed, the debtor found work and earned a total of $9,424 in 2005. In 2004 and 2003, she earned $13,994 and $17,339, respectively.

Despite this modest income, the debtor did not immediately file an adversary proceeding to determine the dischargeability of her student loans. It was almost three years after the entry of her chapter 7 discharge 'on January 3, 2006 that the debtor reopened her chapter 7 case in order to pursue this adversary proceeding.'

In her complaint, the debtor admits that after she received a discharge, she found part-time work with a church and later took a

full-time job as a speech therapist. During 2006, the debtor earned $20,009 and in 2007 she earned $37,314. Hence, while it is clear the debtor's income was very modest in the time period immediately prior to her bankruptcy petition, her financial situation improved during her bankruptcy case.

The court cannot conclude based on the evidence of the debtor's financial circumstances up to the date of the discharge, that she was unable to maintain a minimal standard of living if she was required to repay her students [sic] loans.

However, in January 2007, the debtor was injured in an automobile accident. Her injuries eventually halted the financial progress she had been making and eventually prevented her from working. She now subsists on social security disability payments.

The circumstance creating the debtor's hardship, the automobile accident, occurred after her chapter 7 petition was filed, indeed, approximately one year after her discharge was entered. The debtor is maintaining that this post-petition, post-discharge circumstance warrants a declaration that her student loans were discharged effective from the petition date.

When must the circumstances creating a debtor's hardship arise: before the bankruptcy case is filed; after the case if filed but prior to the entry of a discharge; or at anytime, including after the entry of a discharge?

The court concludes that the circumstances causing a chapter 7 debtor's financial hardship must arise prior to the entry of the discharge. If the circumstances causing a debtor's hardship arise after the entry of a discharge, those circumstances cannot form the basis of a determination that repayment of a student loan will be an undue hardship....

[T]here is nothing in the Bankruptcy Code requiring that a complaint under section 523(a)(8) [to discharge student loans] be filed at any particular point in a bankruptcy case, whether it is filed under chapter 7 or 13. [Relevant Federal Rules of Bankruptcy Procedure] permits such dischargeability complaints to be brought at any time, including after the entry of a discharge and the closing of the bankruptcy case....

While a debtor's decision to file an action to determine the dischargeability of a student loan is not temporally constrained, this does not mean that a debtor's financial hardship may arise after a discharge has been entered.

[The] *Coleman* [case, cited by debtor] deals with the ripeness of a dispute concerning the dischargeability of a student loan. [The Ninth Circuit held that it] is ripe for adjudication at any point during the case. The Ninth Circuit did not conclude, however, that a debtor could rely upon post-discharge circumstances to establish undue hardship. In fact, the court in *Coleman* made clear that the debtor could take a snapshot of the hardship warranting a discharge of a student loan any time *prior* to discharge. [*Coleman* was a Chapter 13 case.]

Here, the debtor was injured in an automobile accident on January 17, 2007, almost exactly one year after her January 3, 2006 chapter 7 discharge. Because the accident had no causal link to the misfortune prompting the debtor to seek bankruptcy relief in the first instance, the accident cannot be relied on to justify the discharge of the student loans because repayment would be an undue hardship.

To hold otherwise would mean that a bankruptcy discharge is a perpetual license to discharge student loans based on events that occur years after the bankruptcy discharge is granted. If a discharged debtor suffers later financial misfortune, that debtor must consider seeking another discharge subject to the limitations imposed by [the sections of the code stipulating how often a person can petition for bankruptcy]. In the context of a second case, the debtor could then ask that the student loan be declared dischargeable under section 523(a)(8).

In this instance, the debtor is now eligible for a discharge in a chapter 13 case. Her chapter 7 petition was filed on September 19, 2005. Section 1328(f)(1) bars a chapter 13 discharge when the debtor has received a chapter 7 discharge in a case commenced in the prior four years. She would not be eligible for a chapter 7 discharge until September 19, 2013.

This is not to say that post-discharge events are irrelevant. The second and third prongs of the *Pena* test require the court to consider whether the circumstances preventing a debtor from repaying a student loan are likely to persist, and whether the debtor has made good faith efforts to repay the student loan. Post-discharge events are relevant to these determinations because they require the court to look into the debtor's financial future.

Unfortunately for the debtor, it is unnecessary to consider the second and third prongs because she cannot satisfy the first prong.

CASE QUESTIONS

1. What is the rationale for making the bankruptcy discharge of student loans very difficult?
2. Petitioner argued that she should be able to use a postdischarge event (the auto accident) as a basis for establishing that she could not maintain a "minimal" standard of living, and thus she should get a retroactive discharge of her student loans. What benefit is there to her if she could successfully make the argument, given that she could—as the court noted—file for Chapter 13?
3. The court cites the *Coleman* case. That was a Chapter 13 proceeding. Here were the facts: Debtor had not yet completed her payments under her five-year repayment plan, and no discharge order had yet been entered; one year into the plan, she was laid off work. She had been trying to repay her student loans for several years, and she claimed she would suffer hardship in committing to the five-year repayment plan without any guarantee that her student loan obligations would be discharged, since she was required to commit all of her disposable income to payments under the plan and would likely be forced to pursue undue hardship issue pro se upon completion of the plan." In *Coleman,* the court held that Debtor could, postfiling but predischarge—one year into the five-year plan—bring up the hardship issue.

   Now, in the case here, after the auto accident, the petitioner "subsists" on Social Security disability payments, and she has almost $150,000 in debt, yet the court prohibited her from claiming a hardship discharge of student loans. Does this result really make sense? Is the court's concern that allowing this postdischarge relief would mean "that a bankruptcy discharge is a perpetual license to discharge student loans based on events that occur years after the bankruptcy discharge is granted" well founded? Suppose it is scheduled to take thirty years to pay off student loans; in year 4, the student-borrower, now Debtor, declares Chapter 7 bankruptcy, student loans not being discharged; in year 6, the person is rendered disabled. What public policy is offended if the person is allowed to "reopen" the bankruptcy and use the postbankruptcy event as a basis for claiming a hardship discharge of student loans?

4. The court suggests she file for Chapter 13. What if—because of timing—the petitioner was not eligible for Chapter 13? What would happen then?

Chapter 11 Bankruptcy

In re Johns-Manville Corp.

36 B.R. 727 (Bkrtcy. N.Y. 1984)

Lifland, Bankruptcy Judge.

Whether an industrial enterprise in the United States is highly successful is often gauged by its "membership" in what has come to be known as the "Fortune 500". Having attained this measure of financial achievement, Johns-Manville Corp. and its affiliated companies (collectively referred to as "Manville") were deemed a paradigm of success in corporate America by the financial community. Thus, Manville's filing for protection under Chapter 11 of Title 11 of the United States Code ("the Code or the Bankruptcy Code") on August 26, 1982 ("the filing date") was greeted with great surprise and consternation on the part of some of its creditors and other corporations that were being sued along with Manville for injuries caused by asbestos exposure. As discussed at length herein, Manville submits that the sole factor necessitating its filing is the mammoth problem of uncontrolled proliferation of asbestos health suits brought against it because of its substantial use for many years of products containing asbestos which injured those who came into contact with the dust of this lethal substance. According to Manville, this current problem of approximately 16,000 lawsuits pending as of the filing date is compounded by the crushing economic burden to be suffered by Manville over the next 20–30 years by the filing of an even more staggering number of suits by those who had been exposed but who will not manifest the asbestos-related diseases until some time during this future period ("the future asbestos claimants"). Indeed, approximately 6,000 asbestos health claims are estimated to have arisen in only the first 16 months since the filing date. This burden is further compounded by the insurance industry's general disavowal of liability to Manville on policies written for this very purpose.

It is the propriety of the filing by Manville which is the subject of the instant decision. Four separate motions to dismiss the petition pursuant to Section 1112(b) of the Code have been lodged before this Court....

Preliminarily, it must be stated that there is no question that Manville is eligible to be a debtor under the Code's statutory requirements. Moreover, it should also be noted that neither Section 109 nor any other provision relating to voluntary petitions by companies contains any insolvency requirement....Accordingly, it is abundantly clear that Manville has met all of the threshold eligibility requirements for filing a voluntary petition under the Code....

A “principal goal” of the Bankruptcy Code is to provide “open access” to the “bankruptcy process.” [Citation.] The rationale behind this “open access” policy is to provide access to bankruptcy relief which is as “open” as “access to the credit economy.” Thus, Congress intended that “there should be no legal barrier to voluntary petitions.” Another major goal of the Code, that of “rehabilitation of debtors,” requires that relief for debtors must be “timely.” Congress declared that it is essential to both the “open access” and “rehabilitation” goals that

[i]nitiating relief should not be a death knell. The process should encourage resort to it, by debtors and creditors, that cuts short the dissipation of assets and the accumulation of debts. Belated commencement of a case may kill an opportunity for reorganization or arrangement.

Accordingly, the drafters of the Code envisioned that a financially beleaguered debtor with real debt and real creditors should not be required to wait until the economic situation is beyond repair in order to file a reorganization petition. The “Congressional purpose” in enacting the Code was to encourage resort to the bankruptcy process. This philosophy not only comports with the elimination of an insolvency requirement, but also is a corollary of the key aim of Chapter 11 of the Code, that of avoidance of liquidation. The drafters of the Code announced this goal, declaring that reorganization is more efficient than liquidation because “assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.” [Citation.] Moreover, reorganization also fosters the goals of preservation of jobs in the threatened entity. [Citation.]

In the instant case, not only would liquidation be wasteful and inefficient in destroying the utility of valuable assets of the companies as well as jobs, but, more importantly, liquidation would preclude just compensation of some present asbestos victims and all future asbestos claimants. This unassailable reality represents all the more reason for this Court to adhere to this basic potential liquidation avoidance aim of Chapter 11 and deny the motions to dismiss. Manville must not be required to wait until its economic picture has deteriorated beyond salvation to file for reorganization.

Clearly, none of the justifications for declaring an abuse of the jurisdiction of the bankruptcy court announced by these courts [in various cases cited] are present in the *Manville* case. In *Manville,* it is undeniable that there has been no sham or hoax perpetrated on the Court in that Manville is a real business with real creditors in pressing need of economic reorganization. Indeed, the Asbestos Committee has belied its own contention that Manville has no debt and no real creditors by quantifying a benchmark settlement demand approaching one billion dollars for compensation of approximately 15,500 pre-petition asbestos claimants, during the course of negotiations pitched toward achieving a consensual plan. This huge asserted liability does not even take into account the estimated 6,000 new asbestos health claims which have arisen in only the first 16 months since the filing date. The number of post-filing claims increases each day as “future claims back into the present.” ...

In short, Manville’s filing did not in the appropriate sense abuse the jurisdiction of this Court and it is indeed, like the debtor in [Citation], a “once viable business supporting employees and unsecured creditors [that] has more recently been burdened with judgments [and suits] that threaten to put it out of existence.” Thus, its petition must be sustained....

In sum, Manville is a financially besieged enterprise in desperate need of reorganization of its crushing real debt, both present and future. The reorganization provisions of the Code were drafted with the aim of liquidation avoidance by great access to Chapter 11. Accordingly, Manville’s filing does not abuse the jurisdictional integrity of this Court, but rather presents the same kinds of reasons that were present in [Citation], for awaiting the determination of Manville’s good faith until it is considered...as a prerequisite to confirmation or as a part of the cadre of motions before me which are scheduled to be heard subsequently.

[A]ll four of the motions to dismiss the Manville petition are denied in their entirety.

CASE QUESTIONS

1. What did Manville want to do here, and why?
2. How does this case demonstrate the fundamental purpose of Chapter 11 as opposed to Chapter 7 filings?
3. The historical background here is that Manville knew from at least 1930 that asbestos—used in many industrial applications—was a deadly carcinogen, and it worked diligently for decades to conceal and obfuscate the fact. What “good faith” argument was raised by the movants in this case?

Chapter 13: What Debts Are Dischargeable?

In re Ryan

389 B.R. 710 9th Cir. BAP, (Idaho, 2008)

On July 13, 1995, Ryan was convicted of possession of an unregistered firearm under 26 U.S.C. § 5861(d) in the United States District Court for the District of Alaska. Ryan was sentenced to fifty-seven months in prison followed by three years of supervised release. In addition, Ryan was ordered to pay a fine of $7,500..., costs of prosecution in the amount of $83,420, and a special assessment of $50.00. Ryan served his sentence. He also paid the $7,500 fine. The district court, following an appellate mandate, ultimately eliminated the restitution obligation.

On April 25, 2003, Ryan filed a petition for bankruptcy relief under chapter 7 in the District of Idaho. He received his chapter 7 discharge on August 11, 2003. Shortly thereafter, Ryan filed a case under chapter 13, listing as his only obligation the amount of unpaid costs of prosecution owed to the United States ("Government")....

Ryan completed payments under the plan, and an "Order of Discharge" was entered on October 5, 2006. The chapter 13 trustee's final report reflected that the Government received $2,774.89 from payments made by Ryan under his plan, but a balance of $77,088.34 on the Government's costs of prosecution claim remained unpaid. Ryan then renewed his request for determination of dischargeability. The bankruptcy court held that the unpaid portion of the Government's claim for costs of prosecution was excepted from discharge by § 1328(a)(3). Ryan appealed.

Section 1328(a)(3) provides an exception to discharge in chapter 13 for "restitution, or a criminal fine." It states, in pertinent part:

[A]s soon as practicable after the completion by the debtor of all payments under the plan, the court shall grant the debtor a discharge of all debts provided for by the plan or disallowed under section 502 of this title except any debt...

(3) for restitution, or a *criminal fine,* included in a sentence on the debtor's conviction of a crime [.] [emphasis added].

The essential question, then, is whether these costs of prosecution constitute a "criminal fine."

Statutory interpretation begins with a review of the particular language used by Congress in the relevant version of the law. [Citation.]

The term "criminal fine" is not defined in [Chapter 13] or anywhere else in the Bankruptcy Code. However, its use in § 1328(a)(3) implicates two important policies embedded in the Bankruptcy Code. First, in light of the objective to provide a fresh start for debtors overburdened by debts that they cannot pay, exceptions to discharge are interpreted strictly against objecting creditors and in favor of debtors. *See, e.g.* [Citations]. In chapter 13, this principle is particularly important because Congress adopted the liberal "superdischarge" provisions of § 1328 as an incentive to debtors to commit to a plan to pay their creditors all of their disposable income over a period of years rather than simply discharging their debts in a chapter 7 liquidation.

"[T]he dischargeability of debts in chapter 13 that are not dischargeable in chapter 7 represents a policy judgment that [it] is preferable for debtors to attempt to pay such debts to the best of their abilities over three years rather than for those debtors to have those debts hanging over their heads indefinitely, perhaps for the rest of their lives." [Citations.]

A second, countervailing policy consideration is a historic deference, both in the Bankruptcy Code and in the administration of prior bankruptcy law, to excepting criminal sanctions from discharge in bankruptcy. Application of this policy is consistent with a general recognition that, "[t]he principal purpose of the Bankruptcy Code is to grant a 'fresh start' to the '*honest* but unfortunate debtor.'" [Citation] (emphasis added [in original]).

The legislative history is clear that [in its 1994 amendments to the bankruptcy law] Congress intended to overrule the result in [of a 1990 Supreme Court case so that]:..."[N]o debtor with criminal restitution obligations will be able to discharge them through any bankruptcy proceeding."...

The imposition on a defendant of the costs of a special prosecutor is different from ordering a defendant to pay criminal fines. Costs are paid to the entity incurring the costs; criminal fines are generally paid to a special fund for victims' compensation and assistance in the U.S. Treasury....

To honor the principle that exceptions to discharge are to be construed narrowly in favor of debtors, particularly in chapter 13, where a broad discharge was provided by Congress as an incentive for debtors to opt for relief under that chapter rather than under chapter 7, it is not appropriate to expand the scope of the [Chapter 13] exception beyond the terms of the statute. Congress could have adopted an exception to discharge in chapter 13 that mirrored [the one in Chapter 7]. It did not do so. In contrast, under [the 2005] BAPCPA, when Congress wanted to limit the chapter 13 "superdischarge," it incorporated exceptions to discharge from [Chapter 7] wholesale....

As a bottom line matter, Ryan served his time and paid in full the criminal fine that was imposed as part of his sentence for

conviction of possession of an unregistered firearm. The restitution obligation that was included as part of his sentence was voided. Ryan paid the Government a total of $6,331.66 to be applied to the costs of prosecution awarded as part of his criminal judgment, including $2,774.89 paid under his chapter 13 plan, leaving a balance of $77,088.34. We determine that the unpaid balance of the costs of prosecution award was covered by Ryan's chapter 13 discharge.

Based on the foregoing analysis, we conclude that the exception to discharge included in [Chapter 13] for "restitution, or a criminal fine, included in a sentence on the debtor's conviction of a crime" does not cover costs of prosecution included in such a sentence, and we REVERSE.

CASE QUESTIONS

1. What is the rationale for making some things dischargeable under Chapter 13 that are not dischargeable under Chapter 7?
2. What is the difference between "criminal restitution" (which in 1994 Congress said could not get discharged at all) and "the costs of prosecution"?
3. Why did the court decide that Ryan's obligation to pay "costs of prosecution" was not precluded by the limits on Chapter 13 bankruptcies imposed by Congress?

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14.7.8: 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?

SELF-TEST QUESTIONS

1. Alternatives to bankruptcy include a. an assignment
   b. a composition
   c. receivership
   d. all of the above
2. A composition is a. a procedure where a receiver takes over the debtor's property
   b. an agreement by creditors to take less than the face value of their debt
   c. basically the same as an assignment
   d. none of these
3. The highest-priority class set out by the 2005 act is for a. employees' wages
   b. administrative expenses
   c. property settlements arising from divorce
   d.domestic support obligations
4. Darlene Debtor did the following within ninety days of filing for bankruptcy. Which could be set aside as a preferential payment? a. paid water and electricity bills
   b. made a gift to the Humane Society
   c. prepaid an installment loan on inventory
   d. borrowed money from a bank secured by a mortgage on business property
5. Donald Debtor sold his 1957 Chevrolet to his brother for one-fifth its value sixty days before filing for bankruptcy. The trustee wishes to avoid the transaction on the basis that it was a. a hypothetical lien
   b. a lease disguised as a sale
   c. a preferential payment
   d.a voidable preference
6. Acme Co. filed for bankruptcy with the following debts; which is their correct priority from highest to lowest?

   i. wages of $15,000 owed to employees

   ii. unpaid federal taxes

   iii. balance owed to a creditor who claimed its security with a $5,000 deficiency owing

a. i, ii, iii
b. ii, iii, i
c. iii, ii, i
d. i, iii, ii

SELF-TEST AnswerS

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

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14.8.1: Chapter Introduction

Learning Objectives

After reading this chapter, you should understand the following:

1. A short history of US bankruptcy law
2. An overview of key provisions of the 2005 bankruptcy act
3. The basic operation of Chapter 7 bankruptcy
4. The basic operation of Chapter 11 bankruptcy
5. The basic operation of Chapter 13 bankruptcy
6. What debtor's relief is available outside of bankruptcy

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14.8.2: Introductin to Bankruptcy and Overview of the 2005 Bankruptcy Act

Learning Objectives

1. Understand what law governs bankruptcy in the United States.
2. 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.

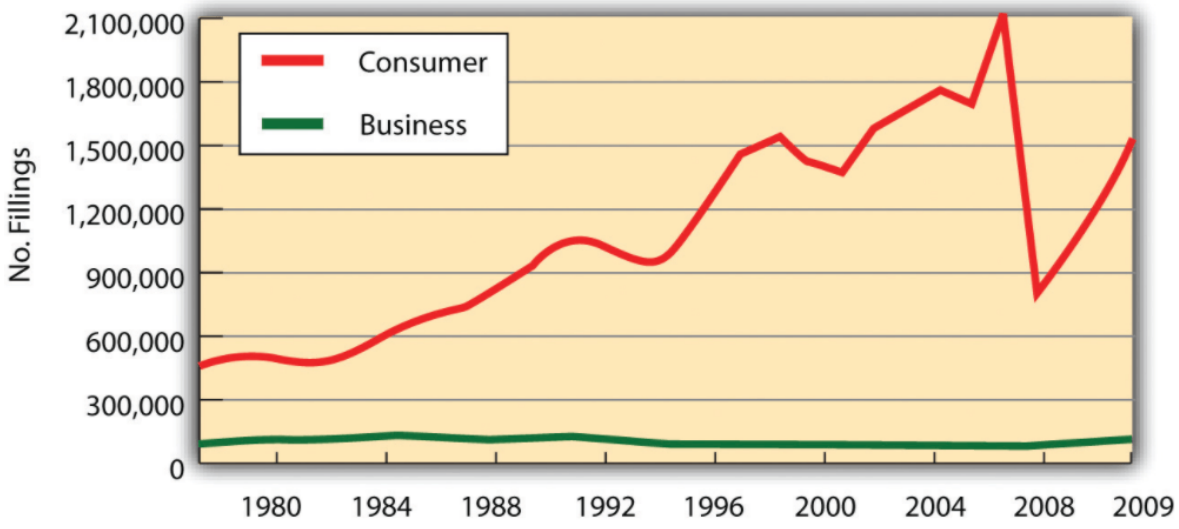
Bankruptcy Statutes

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 35.1 "US Bankruptcies, 1980–2009"). 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, http://www.cch.com/bankruptcy/bankruptcy_04-21.pdf.—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 35.1 US Bankruptcies, 1980–2009



Bankruptcy Action.com, www.bankruptcyaction.com/USbankstats.htm, statistics from Administrative Office of the Courts.

Bankruptcy Courts, Judges, and Costs

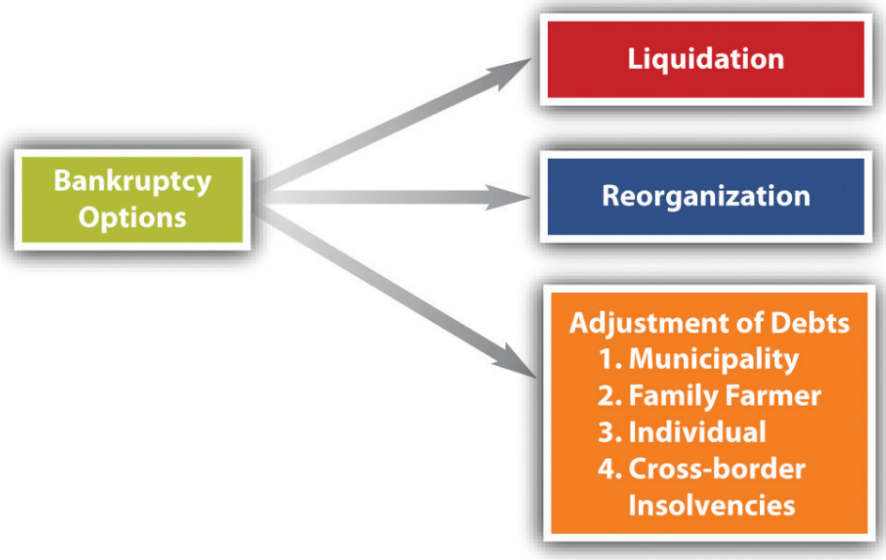
Each federal judicial district has a US Bankruptcy Court, whose judges are appointed by US Courts of Appeal. Unless both sides agree otherwise, bankruptcy judges are to hear only bankruptcy matters (called core proceedings). Bankruptcy trustees are government lawyers appointed by the US Attorney General. They have administrative responsibilities in overseeing the proceedings.

The filing fee for a bankruptcy is about $200, depending upon the type of bankruptcy, and the typical lawyer's fee for uncomplicated cases is about $1,200–$1,400.

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 35.2 "Bankruptcy Options").

Figure 35.2 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:

- 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 35.5 "Alternatives to Bankruptcy", "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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14.8.3: Case Administration; Creditors' Claims; Debtors' Exemptions and Dischargeable Debts; Debtor's Estate

Learning Objectives

1. Understand the basic procedures involved in administering a bankruptcy case.
2. Recognize the basic elements of creditors' rights under the bankruptcy code.
3. Understand the fundamentals of what property is included in the debtor's estate.
4. Identify some of the debtor's exemptions—what property can be kept by the debtor.
5. Know some of the debts that cannot be discharged in bankruptcy.
6. 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. To put anyone into bankruptcy involuntarily, the petitioning creditors must meet three conditions: (1) they must have claims for unsecured debt amounting to at least $13,475; (2) three creditors must join in the petition whenever twelve or more creditors have claims against the particular debtor—otherwise, one creditor may file an involuntary petition, as long as his claim is for at least $13,475; (3) there must be no bona fide dispute about the debt owing. If there is a dispute, the debtor can resist the involuntary filing, and if she wins the dispute, the creditors who pushed for the involuntary petition have to pay the associated costs. Persons owing less than $13,475, farmers, and charitable organizations cannot be forced into bankruptcy.

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 35.3 "Chapter 7 Liquidation".

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 (as discussed in Chapter 33 "Secured Transactions and Suretyship" and Chapter 34 "Mortgages and Nonconsensual Liens"). 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 35.3 "Distribution of the Estate"), 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 35.3 "Chapter 7 Liquidation".

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 35.6 "Cases", *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 35.3 "Chapter 7 Liquidation", 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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14.8.4: Chapter 7 Liquidation

Learning Objectives

1. Recognize the grounds for a Chapter 7 case to be dismissed.
2. Be familiar with the BAPCPA's means-testing requirements before Chapter 7 discharge is granted.
3. Know under what circumstances a debtor will be denied discharge.
4. 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.

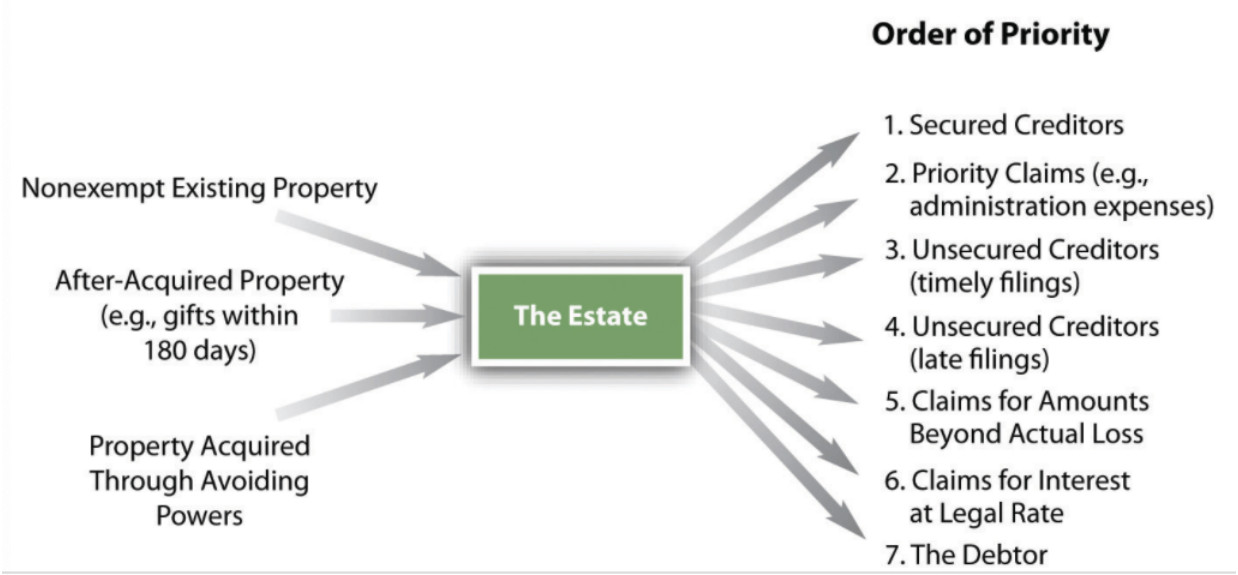
Distribution of the Estate and Discharge; Denying Discharge

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/...10th/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 35.3 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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14.8: BANKRUPTCY (1)

14.8.1: Chapter Introduction

14.8.2: Introductin to Bankruptcy and Overview of the 2005 Bankruptcy Act

14.8.3: Case Administration; Creditors' Claims; Debtors' Exemptions and Dischargeable Debts; Debtor's Estate

14.8.4: Chapter 7 Liquidation

14.8.5: Chapter 11 and Chapter 13 Bankruptcies

14.8.6: Alternatives to Bankruptcy

14.8.7: Cases

14.8.8: Summary and Exercises

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14.8.5: Chapter 11 and Chapter 13 Bankruptcies

Learning Objectives

1. Understand the basic concepts of Chapter 11 bankruptcies.
2. 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 35.2 "Case Administration; Creditors' Claims; Debtors' Exemptions and Dischargeable Debts; Debtor's Estate", 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 $336,000, and secured debts of less than $1,010,650 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 35.6 "Cases", *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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14.8.6: Alternatives to Bankruptcy

Learning Objectives

1. 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.
2. 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

Assignment for 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

A **composition** 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, composition 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 composition lies in the creditors' agreement: an assignment implies no agreement among the creditors, whereas a composition does. Not all creditors of the particular debtor need agree to the composition for it to be valid. A creditor who does not agree to the composition 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 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 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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14.8.7: Cases

Dischargeability of Student Loans under Chapter 7

In re Zygarewicz

423 B.R. 909 (Bkrtcy.E.D.Cal. 2010)

MCMANUS, BANKRUPTCY JUDGE.

Angela Zygarewicz, a chapter 7 debtor and the plaintiff in this adversary proceeding, borrowed 16 government-guaranteed student [sic] loans totaling $81,429. The loans have been assigned to Educational Credit Management Corporation ("ECMC"). By September 2009, the accrual of interest on these student loans had caused the debt to balloon to more than $146,000. The debtor asks the court to declare that these student loans were discharged in bankruptcy.

The Bankruptcy Code provides financially distressed debtors with a fresh start by discharging most of their pre-petition debts....However, under 11 U.S.C. § 523(a)(8), there is a presumption that educational loans extended by or with the aid of a governmental unit or nonprofit institution are nondischargeable unless the debtor can demonstrate that their repayment would be an undue hardship. See [Citation]. This exception to a bankruptcy discharge ensures that student loans, which are typically extended solely on the basis of the student's future earnings potential, cannot be discharged by recent graduates who then pocket all of the future benefits derived from their education. See [Citation].

The debtor bears the burden of proving by a preponderance of the evidence that she is entitled to a discharge of the student loan. See [Citation]. That is, the debtor must prove that repayment of student loans will cause an undue hardship.

The Bankruptcy Code does not define "the undue hardship." Courts interpreting section 523(a)(8), however, have concluded that undue hardship [and] is something more than "garden-variety hardship." [Citation.] Only cases involving "real and substantial" hardship merit discharges. See [Citation.]

The Ninth Circuit has adopted a three-part test to guide courts in their attempts to determine whether a debtor will suffer an undue hardship is required to repay a student loan:

- First, the debtor must establish "that she cannot maintain, based on current income and expenses, a 'minimal' standard of living for herself and her dependents if forced to repay the loans."...
- Second, the debtor must show "that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans."...
- The third prong requires "that the debtor has made good faith efforts to repay the loans...."

(*Pena,* citing *Brunner v. N.Y. State Higher Educ. Servs. Corp.*, [Citation]).

Debtor must satisfy all three parts of the *Brunner* test before her student loans can be discharged. Failure to prove any of the three prongs will defeat a debtor's case.

When this bankruptcy case was filed in September 2005, the debtor was a single woman and had no dependents. She is 39 years old.

Schedule I reported that the debtor was unemployed. The debtor's responses to the Statement of Financial Affairs revealed that she had received $5,500 in income during 2005 prior to the filing of the petition. Evidence at trial indicated that after the petition was filed, the debtor found work and earned a total of $9,424 in 2005. In 2004 and 2003, she earned $13,994 and $17,339, respectively.

Despite this modest income, the debtor did not immediately file an adversary proceeding to determine the dischargeability of her student loans. It was almost three years after the entry of her chapter 7 discharge 'on January 3, 2006 that the debtor reopened her chapter 7 case in order to pursue this adversary proceeding.'

In her complaint, the debtor admits that after she received a discharge, she found part-time work with a church and later took a

full-time job as a speech therapist. During 2006, the debtor earned $20,009 and in 2007 she earned $37,314. Hence, while it is clear the debtor's income was very modest in the time period immediately prior to her bankruptcy petition, her financial situation improved during her bankruptcy case.

The court cannot conclude based on the evidence of the debtor's financial circumstances up to the date of the discharge, that she was unable to maintain a minimal standard of living if she was required to repay her students [sic] loans.

However, in January 2007, the debtor was injured in an automobile accident. Her injuries eventually halted the financial progress she had been making and eventually prevented her from working. She now subsists on social security disability payments.

The circumstance creating the debtor's hardship, the automobile accident, occurred after her chapter 7 petition was filed, indeed, approximately one year after her discharge was entered. The debtor is maintaining that this post-petition, post-discharge circumstance warrants a declaration that her student loans were discharged effective from the petition date.

When must the circumstances creating a debtor's hardship arise: before the bankruptcy case is filed; after the case if filed but prior to the entry of a discharge; or at anytime, including after the entry of a discharge?

The court concludes that the circumstances causing a chapter 7 debtor's financial hardship must arise prior to the entry of the discharge. If the circumstances causing a debtor's hardship arise after the entry of a discharge, those circumstances cannot form the basis of a determination that repayment of a student loan will be an undue hardship....

[T]here is nothing in the Bankruptcy Code requiring that a complaint under section 523(a)(8) [to discharge student loans] be filed at any particular point in a bankruptcy case, whether it is filed under chapter 7 or 13. [Relevant Federal Rules of Bankruptcy Procedure] permits such dischargeability complaints to be brought at any time, including after the entry of a discharge and the closing of the bankruptcy case....

While a debtor's decision to file an action to determine the dischargeability of a student loan is not temporally constrained, this does not mean that a debtor's financial hardship may arise after a discharge has been entered.

[The] *Coleman* [case, cited by debtor] deals with the ripeness of a dispute concerning the dischargeability of a student loan. [The Ninth Circuit held that it] is ripe for adjudication at any point during the case. The Ninth Circuit did not conclude, however, that a debtor could rely upon post-discharge circumstances to establish undue hardship. In fact, the court in *Coleman* made clear that the debtor could take a snapshot of the hardship warranting a discharge of a student loan any time *prior* to discharge. [*Coleman* was a Chapter 13 case.]

Here, the debtor was injured in an automobile accident on January 17, 2007, almost exactly one year after her January 3, 2006 chapter 7 discharge. Because the accident had no causal link to the misfortune prompting the debtor to seek bankruptcy relief in the first instance, the accident cannot be relied on to justify the discharge of the student loans because repayment would be an undue hardship.

To hold otherwise would mean that a bankruptcy discharge is a perpetual license to discharge student loans based on events that occur years after the bankruptcy discharge is granted. If a discharged debtor suffers later financial misfortune, that debtor must consider seeking another discharge subject to the limitations imposed by [the sections of the code stipulating how often a person can petition for bankruptcy]. In the context of a second case, the debtor could then ask that the student loan be declared dischargeable under section 523(a)(8).

In this instance, the debtor is now eligible for a discharge in a chapter 13 case. Her chapter 7 petition was filed on September 19, 2005. Section 1328(f)(1) bars a chapter 13 discharge when the debtor has received a chapter 7 discharge in a case commenced in the prior four years. She would not be eligible for a chapter 7 discharge until September 19, 2013.

This is not to say that post-discharge events are irrelevant. The second and third prongs of the *Pena* test require the court to consider whether the circumstances preventing a debtor from repaying a student loan are likely to persist, and whether the debtor has made good faith efforts to repay the student loan. Post-discharge events are relevant to these determinations because they require the court to look into the debtor's financial future.

Unfortunately for the debtor, it is unnecessary to consider the second and third prongs because she cannot satisfy the first prong.

CASE QUESTIONS

1. What is the rationale for making the bankruptcy discharge of student loans very difficult?
2. Petitioner argued that she should be able to use a postdischarge event (the auto accident) as a basis for establishing that she could not maintain a "minimal" standard of living, and thus she should get a retroactive discharge of her student loans. What benefit is there to her if she could successfully make the argument, given that she could—as the court noted—file for Chapter 13?
3. The court cites the *Coleman* case. That was a Chapter 13 proceeding. Here were the facts: Debtor had not yet completed her payments under her five-year repayment plan, and no discharge order had yet been entered; one year into the plan, she was laid off work. She had been trying to repay her student loans for several years, and she claimed she would suffer hardship in committing to the five-year repayment plan without any guarantee that her student loan obligations would be discharged, since she was required to commit all of her disposable income to payments under the plan and would likely be forced to pursue undue hardship issue pro se upon completion of the plan." In *Coleman,* the court held that Debtor could, postfiling but predischarge—one year into the five-year plan—bring up the hardship issue.

   Now, in the case here, after the auto accident, the petitioner "subsists" on Social Security disability payments, and she has almost $150,000 in debt, yet the court prohibited her from claiming a hardship discharge of student loans. Does this result really make sense? Is the court's concern that allowing this postdischarge relief would mean "that a bankruptcy discharge is a perpetual license to discharge student loans based on events that occur years after the bankruptcy discharge is granted" well founded? Suppose it is scheduled to take thirty years to pay off student loans; in year 4, the student-borrower, now Debtor, declares Chapter 7 bankruptcy, student loans not being discharged; in year 6, the person is rendered disabled. What public policy is offended if the person is allowed to "reopen" the bankruptcy and use the postbankruptcy event as a basis for claiming a hardship discharge of student loans?

4. The court suggests she file for Chapter 13. What if—because of timing—the petitioner was not eligible for Chapter 13? What would happen then?

Chapter 11 Bankruptcy

In re Johns-Manville Corp.

36 B.R. 727 (Bkrtcy. N.Y. 1984)

Lifland, Bankruptcy Judge.

Whether an industrial enterprise in the United States is highly successful is often gauged by its "membership" in what has come to be known as the "Fortune 500". Having attained this measure of financial achievement, Johns-Manville Corp. and its affiliated companies (collectively referred to as "Manville") were deemed a paradigm of success in corporate America by the financial community. Thus, Manville's filing for protection under Chapter 11 of Title 11 of the United States Code ("the Code or the Bankruptcy Code") on August 26, 1982 ("the filing date") was greeted with great surprise and consternation on the part of some of its creditors and other corporations that were being sued along with Manville for injuries caused by asbestos exposure. As discussed at length herein, Manville submits that the sole factor necessitating its filing is the mammoth problem of uncontrolled proliferation of asbestos health suits brought against it because of its substantial use for many years of products containing asbestos which injured those who came into contact with the dust of this lethal substance. According to Manville, this current problem of approximately 16,000 lawsuits pending as of the filing date is compounded by the crushing economic burden to be suffered by Manville over the next 20–30 years by the filing of an even more staggering number of suits by those who had been exposed but who will not manifest the asbestos-related diseases until some time during this future period ("the future asbestos claimants"). Indeed, approximately 6,000 asbestos health claims are estimated to have arisen in only the first 16 months since the filing date. This burden is further compounded by the insurance industry's general disavowal of liability to Manville on policies written for this very purpose.

It is the propriety of the filing by Manville which is the subject of the instant decision. Four separate motions to dismiss the petition pursuant to Section 1112(b) of the Code have been lodged before this Court....

Preliminarily, it must be stated that there is no question that Manville is eligible to be a debtor under the Code's statutory requirements. Moreover, it should also be noted that neither Section 109 nor any other provision relating to voluntary petitions by companies contains any insolvency requirement....Accordingly, it is abundantly clear that Manville has met all of the threshold eligibility requirements for filing a voluntary petition under the Code....

A “principal goal” of the Bankruptcy Code is to provide “open access” to the “bankruptcy process.” [Citation.] The rationale behind this “open access” policy is to provide access to bankruptcy relief which is as “open” as “access to the credit economy.” Thus, Congress intended that “there should be no legal barrier to voluntary petitions.” Another major goal of the Code, that of “rehabilitation of debtors,” requires that relief for debtors must be “timely.” Congress declared that it is essential to both the “open access” and “rehabilitation” goals that

[i]nitiating relief should not be a death knell. The process should encourage resort to it, by debtors and creditors, that cuts short the dissipation of assets and the accumulation of debts. Belated commencement of a case may kill an opportunity for reorganization or arrangement.

Accordingly, the drafters of the Code envisioned that a financially beleaguered debtor with real debt and real creditors should not be required to wait until the economic situation is beyond repair in order to file a reorganization petition. The “Congressional purpose” in enacting the Code was to encourage resort to the bankruptcy process. This philosophy not only comports with the elimination of an insolvency requirement, but also is a corollary of the key aim of Chapter 11 of the Code, that of avoidance of liquidation. The drafters of the Code announced this goal, declaring that reorganization is more efficient than liquidation because “assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.” [Citation.] Moreover, reorganization also fosters the goals of preservation of jobs in the threatened entity. [Citation.]

In the instant case, not only would liquidation be wasteful and inefficient in destroying the utility of valuable assets of the companies as well as jobs, but, more importantly, liquidation would preclude just compensation of some present asbestos victims and all future asbestos claimants. This unassailable reality represents all the more reason for this Court to adhere to this basic potential liquidation avoidance aim of Chapter 11 and deny the motions to dismiss. Manville must not be required to wait until its economic picture has deteriorated beyond salvation to file for reorganization.

Clearly, none of the justifications for declaring an abuse of the jurisdiction of the bankruptcy court announced by these courts [in various cases cited] are present in the *Manville* case. In *Manville,* it is undeniable that there has been no sham or hoax perpetrated on the Court in that Manville is a real business with real creditors in pressing need of economic reorganization. Indeed, the Asbestos Committee has belied its own contention that Manville has no debt and no real creditors by quantifying a benchmark settlement demand approaching one billion dollars for compensation of approximately 15,500 pre-petition asbestos claimants, during the course of negotiations pitched toward achieving a consensual plan. This huge asserted liability does not even take into account the estimated 6,000 new asbestos health claims which have arisen in only the first 16 months since the filing date. The number of post-filing claims increases each day as “future claims back into the present.” ...

In short, Manville’s filing did not in the appropriate sense abuse the jurisdiction of this Court and it is indeed, like the debtor in [Citation], a “once viable business supporting employees and unsecured creditors [that] has more recently been burdened with judgments [and suits] that threaten to put it out of existence.” Thus, its petition must be sustained....

In sum, Manville is a financially besieged enterprise in desperate need of reorganization of its crushing real debt, both present and future. The reorganization provisions of the Code were drafted with the aim of liquidation avoidance by great access to Chapter 11. Accordingly, Manville’s filing does not abuse the jurisdictional integrity of this Court, but rather presents the same kinds of reasons that were present in [Citation], for awaiting the determination of Manville’s good faith until it is considered...as a prerequisite to confirmation or as a part of the cadre of motions before me which are scheduled to be heard subsequently.

[A]ll four of the motions to dismiss the Manville petition are denied in their entirety.

CASE QUESTIONS

1. What did Manville want to do here, and why?
2. How does this case demonstrate the fundamental purpose of Chapter 11 as opposed to Chapter 7 filings?
3. The historical background here is that Manville knew from at least 1930 that asbestos—used in many industrial applications—was a deadly carcinogen, and it worked diligently for decades to conceal and obfuscate the fact. What “good faith” argument was raised by the movants in this case?

Chapter 13: What Debts Are Dischargeable?

In re Ryan

389 B.R. 710 9th Cir. BAP, (Idaho, 2008)

On July 13, 1995, Ryan was convicted of possession of an unregistered firearm under 26 U.S.C. § 5861(d) in the United States District Court for the District of Alaska. Ryan was sentenced to fifty-seven months in prison followed by three years of supervised release. In addition, Ryan was ordered to pay a fine of $7,500..., costs of prosecution in the amount of $83,420, and a special assessment of $50.00. Ryan served his sentence. He also paid the $7,500 fine. The district court, following an appellate mandate, ultimately eliminated the restitution obligation.

On April 25, 2003, Ryan filed a petition for bankruptcy relief under chapter 7 in the District of Idaho. He received his chapter 7 discharge on August 11, 2003. Shortly thereafter, Ryan filed a case under chapter 13, listing as his only obligation the amount of unpaid costs of prosecution owed to the United States ("Government")....

Ryan completed payments under the plan, and an "Order of Discharge" was entered on October 5, 2006. The chapter 13 trustee's final report reflected that the Government received $2,774.89 from payments made by Ryan under his plan, but a balance of $77,088.34 on the Government's costs of prosecution claim remained unpaid. Ryan then renewed his request for determination of dischargeability. The bankruptcy court held that the unpaid portion of the Government's claim for costs of prosecution was excepted from discharge by § 1328(a)(3). Ryan appealed.

Section 1328(a)(3) provides an exception to discharge in chapter 13 for "restitution, or a criminal fine." It states, in pertinent part:

[A]s soon as practicable after the completion by the debtor of all payments under the plan, the court shall grant the debtor a discharge of all debts provided for by the plan or disallowed under section 502 of this title except any debt...

(3) for restitution, or a *criminal fine,* included in a sentence on the debtor's conviction of a crime [.] [emphasis added].

The essential question, then, is whether these costs of prosecution constitute a "criminal fine."

Statutory interpretation begins with a review of the particular language used by Congress in the relevant version of the law. [Citation.]

The term "criminal fine" is not defined in [Chapter 13] or anywhere else in the Bankruptcy Code. However, its use in § 1328(a)(3) implicates two important policies embedded in the Bankruptcy Code. First, in light of the objective to provide a fresh start for debtors overburdened by debts that they cannot pay, exceptions to discharge are interpreted strictly against objecting creditors and in favor of debtors. *See, e.g.* [Citations]. In chapter 13, this principle is particularly important because Congress adopted the liberal "superdischarge" provisions of § 1328 as an incentive to debtors to commit to a plan to pay their creditors all of their disposable income over a period of years rather than simply discharging their debts in a chapter 7 liquidation.

"[T]he dischargeability of debts in chapter 13 that are not dischargeable in chapter 7 represents a policy judgment that [it] is preferable for debtors to attempt to pay such debts to the best of their abilities over three years rather than for those debtors to have those debts hanging over their heads indefinitely, perhaps for the rest of their lives." [Citations.]

A second, countervailing policy consideration is a historic deference, both in the Bankruptcy Code and in the administration of prior bankruptcy law, to excepting criminal sanctions from discharge in bankruptcy. Application of this policy is consistent with a general recognition that, "[t]he principal purpose of the Bankruptcy Code is to grant a 'fresh start' to the '*honest* but unfortunate debtor.'" [Citation] (emphasis added [in original]).

The legislative history is clear that [in its 1994 amendments to the bankruptcy law] Congress intended to overrule the result in [of a 1990 Supreme Court case so that]:..."[N]o debtor with criminal restitution obligations will be able to discharge them through any bankruptcy proceeding."...

The imposition on a defendant of the costs of a special prosecutor is different from ordering a defendant to pay criminal fines. Costs are paid to the entity incurring the costs; criminal fines are generally paid to a special fund for victims' compensation and assistance in the U.S. Treasury....

To honor the principle that exceptions to discharge are to be construed narrowly in favor of debtors, particularly in chapter 13, where a broad discharge was provided by Congress as an incentive for debtors to opt for relief under that chapter rather than under chapter 7, it is not appropriate to expand the scope of the [Chapter 13] exception beyond the terms of the statute. Congress could have adopted an exception to discharge in chapter 13 that mirrored [the one in Chapter 7]. It did not do so. In contrast, under [the 2005] BAPCPA, when Congress wanted to limit the chapter 13 "superdischarge," it incorporated exceptions to discharge from [Chapter 7] wholesale....

As a bottom line matter, Ryan served his time and paid in full the criminal fine that was imposed as part of his sentence for

conviction of possession of an unregistered firearm. The restitution obligation that was included as part of his sentence was voided. Ryan paid the Government a total of $6,331.66 to be applied to the costs of prosecution awarded as part of his criminal judgment, including $2,774.89 paid under his chapter 13 plan, leaving a balance of $77,088.34. We determine that the unpaid balance of the costs of prosecution award was covered by Ryan's chapter 13 discharge.

Based on the foregoing analysis, we conclude that the exception to discharge included in [Chapter 13] for "restitution, or a criminal fine, included in a sentence on the debtor's conviction of a crime" does not cover costs of prosecution included in such a sentence, and we REVERSE.

CASE QUESTIONS

1. What is the rationale for making some things dischargeable under Chapter 13 that are not dischargeable under Chapter 7?
2. What is the difference between "criminal restitution" (which in 1994 Congress said could not get discharged at all) and "the costs of prosecution"?
3. Why did the court decide that Ryan's obligation to pay "costs of prosecution" was not precluded by the limits on Chapter 13 bankruptcies imposed by Congress?

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14.8.8: 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?

SELF-TEST QUESTIONS

1. Alternatives to bankruptcy include a. an assignment
   b. a composition
   c. receivership
   d. all of the above
2. A composition is a. a procedure where a receiver takes over the debtor's property
   b. an agreement by creditors to take less than the face value of their debt
   c. basically the same as an assignment
   d. none of these
3. The highest-priority class set out by the 2005 act is for a. employees' wages
   b. administrative expenses
   c. property settlements arising from divorce
   d.domestic support obligations
4. Darlene Debtor did the following within ninety days of filing for bankruptcy. Which could be set aside as a preferential payment? a. paid water and electricity bills
   b. made a gift to the Humane Society
   c. prepaid an installment loan on inventory
   d. borrowed money from a bank secured by a mortgage on business property
5. Donald Debtor sold his 1957 Chevrolet to his brother for one-fifth its value sixty days before filing for bankruptcy. The trustee wishes to avoid the transaction on the basis that it was a. a hypothetical lien
   b. a lease disguised as a sale
   c. a preferential payment
   d.a voidable preference
6. Acme Co. filed for bankruptcy with the following debts; which is their correct priority from highest to lowest?

   i. wages of $15,000 owed to employees

   ii. unpaid federal taxes

   iii. balance owed to a creditor who claimed its security with a $5,000 deficiency owing

a. i, ii, iii
b. ii, iii, i
c. iii, ii, i
d. i, iii, ii

SELF-TEST AnswerS

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

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15: ANTITRUST LAW

15.1: Introduction to Antitrust Law
15.2: History of Antitrust Law
15.3: Antitrust Laws
15.4: End Notes
15.5: Assessment Questions

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15.1: Introduction to Antitrust Law

Learning Objectives

- Analyze the tenets of antitrust laws in the United States.

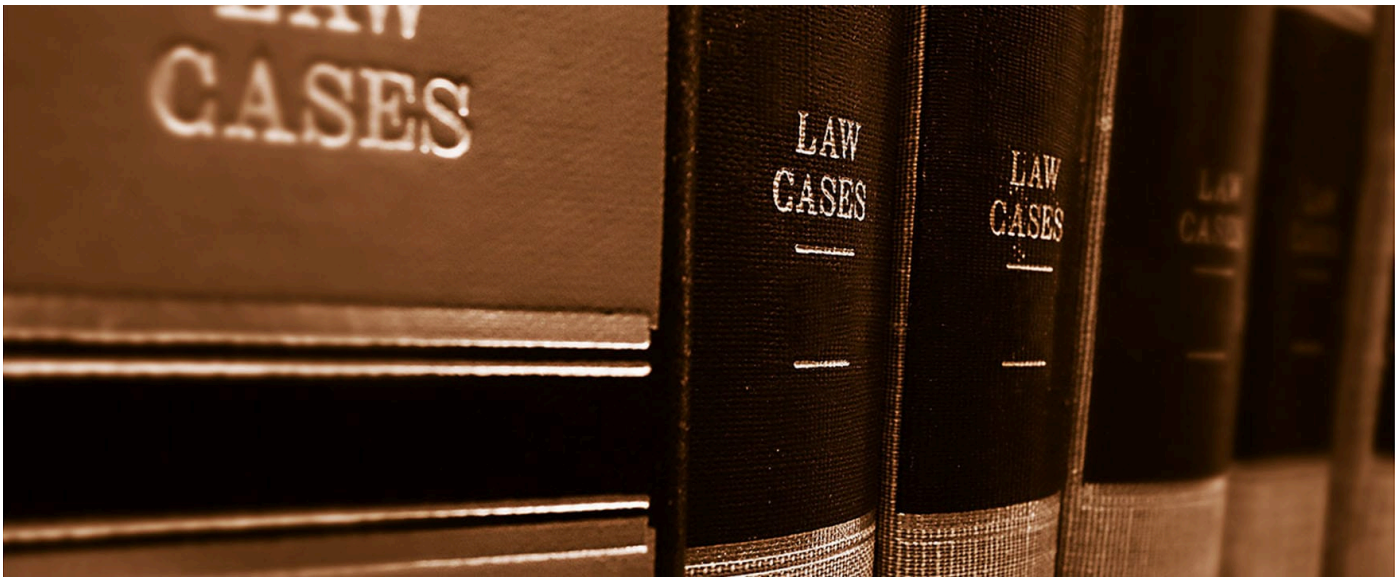


Figure 15.1.1: Introduction (Credit: witwiccan/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

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15.2: History of Antitrust Law

What if the two largest manufacturers of soft drinks, Coca Cola Co. and PepsiCo, merged? It is likely that the mega-company that resulted would dominate the soft drink industry, squeezing out all of the other smaller competitors.

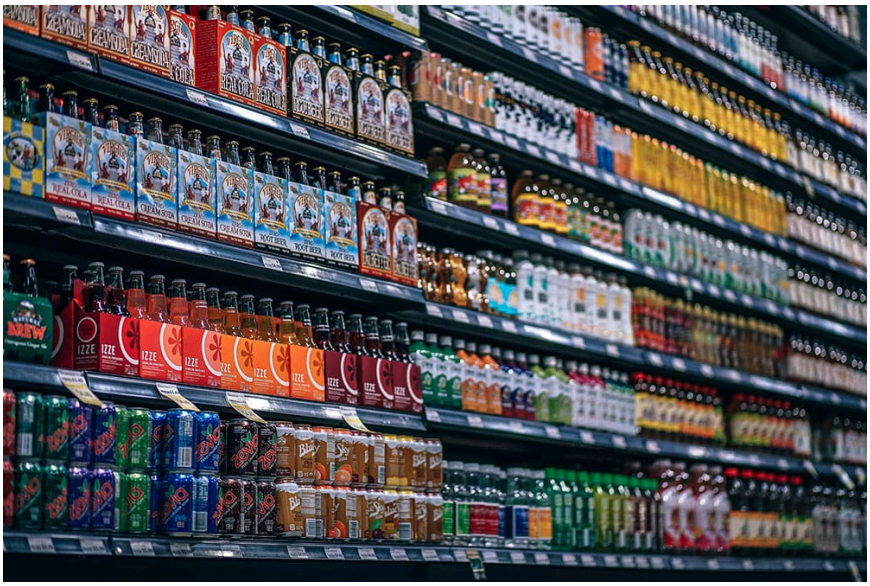


Figure 15.2.1: Without antitrust laws, the shelves would have fewer products for consumers to choose from. Image: Beverages, Bottles, Shelf. (Credit: igorovsyannyko/ pixabay/ License: CC0)

In the late 1800s, concern over this kind of merger, as well as other attempts by large companies to create monopolies or to control the market, led state and federal lawmakers to take steps to reduce the risks associated with this type of practice.

Business Trusts

During the late 1800s, the United States became concerned about the development of corporate monopolies dominating the manufacturing and mining industries (Jurist, n.d.). The end of the Civil War marked the beginning of large advances in industrialization. Many large companies formed, especially in the oil and steel industries, which were two industries that the country was beginning to heavily rely on. Manufacturing and distributing companies grew at a fast pace in a wide variety of industries, ranging from sugar to beef to tobacco (West, n.d.). The problem was that the growth occurred so rapidly that supply exceeded demand. This outcome increased competition, and many companies sought to reduce the number of competitors through forms of **restraint of trade** such as price-fixing, monopolies, and mergers (West, n.d.).



Figure 15.2.2: The oil industry expanded quicker than demand, causing companies to try to remove competition. (Credit: 15299/ pixabay/ License: CC0)

Some of the competitors were larger and more powerful than others, and they sought to limit the competition in the market by taking steps to reduce the number of smaller companies who were trying to compete with them (Federal Trade Commission, n.d.). Some of the larger companies banded together to create **business trusts**. A business trust is a trust agreement that allows businesses to maintain profits as beneficiaries, but legal ownership and management of the company's property is maintained through the power of trustees (West, n.d.). These trusts allowed businesses that were members of the trust to grow larger, as they cooperated with one another and shut out other competitors (West, n.d.).

Unfair Business Practices

Companies tried to create situations that would drive some competitors out of business while solidifying their own share of the market. This effort resulted in mergers and consolidation practices that placed the largest share of the industries under the control of just a few, thereby increasing their power. Since the trusts were able to fix prices and could afford to take some losses, they would drive prices down until competitors were forced out of business because they could not afford to operate at the lower rates (West. n.d.).

The markets began to consolidate under just a few companies because the smaller competitors continued to go out of business. The smaller competitors could not compete with the pricing and other practices that the trusts allowed the cooperative businesses to maintain. This design restricted free trade practices for both businesses and consumers. The few businesses in the trust, in turn, became more powerful, thus prompting the government to look for measures to control the situation (Federal Trade Commission, n.d.). The government determined that laws needed to be created to prevent this form of trade restriction.

Rule of Reason

Unfair business practices did not reside solely with business trusts. Issues also occurred in agreements between competitors, contracts entered into between sellers and buyers, and practices that created or maintained cartels, monopolies, and mergers (West, n.d.). There were no specific laws that regulated these practices, so the courts were not entirely sure how to deal with them. Initially, courts seemed to swing both ways, both accepting and condemning certain forms of restraint of trade. Rulings were not consistent from state to state, and guidelines needed to be established. The guiding condition seemed to be whether or not the restraints prevented other merchants from entering the market (West, n.d.).

The courts used the **rule of reason** as the standard. The rule of reason explored the goal of the contract, which was considered either naked restraint or ancillary restraint. **Naked restraint** occurs as contracts promote a general restraint of competition. If the restraint was created with a goal of long-term impact without boundaries, it was considered to be a naked restraint (West, nd.). **Ancillary restraint** occurs as the restriction is limited in time and geography (West, n.d.). With ancillary restraint, the restraint would be short-term and limited in scope. The courts tended to frown upon naked restraint, but were less consistent with ancillary restraint. Initially, there did not seem to be a comprehensive common law applied similarly from state to state (West, n.d.). This

problem was concerning enough to warrant a solution, and in 1890, the first antitrust law was enacted (Jurist, n.d.).

Antitrust Laws

Antitrust laws regulate economic competition in an effort to maintain fair trade practices (West, n.d.). They were created to prevent the restraints on trade created by trusts and other large company practices. These restraints often resulted in price-fixing, control of production, and control of geographical markets (Jurist, n.d.). Many states recognized these outcomes as a threat to fair business practices. The federal government also recognized this issue and developed antitrust laws in 1887 as a result of a Standard Oil trust that was formed. The Standard Oil Trust occurred as oil companies transferred their stocks to a trustee to create a more powerful block of oil companies that prevented other oil companies from effectively competing with them (West, n.d.).

The first antitrust law created was the Sherman Antitrust Act in 1890, which became the basis for subsequent antitrust laws (Jurist, 2013). The Sherman Act was a good start, but it was not comprehensive enough to prevent trusts, and large companies continued to exert strong control over industries. At the turn of the century, a few large companies controlled almost half of all of the nation's manufacturing assets (West, n.d.). It became evident that more legislation was necessary. President Theodore Roosevelt dubbed himself a "trustbuster," and he began a campaign to create more effective legal endeavors (West, n.d.). Additional antitrust acts were passed in 1914, including the Clayton Act and the Federal Trade Commission Act. These acts are still in effect, and since 1914, they have been amended by Congress to continue to expand upon and solidify the coverage. It is estimated that antitrust laws save consumers millions of dollars a year, as they prohibit business practices that unfairly raise prices on goods and services (United States Department of Justice, n.d.).

Conclusion

The original purpose of antitrust legislation, i.e., to foster competition that results in lower prices, more products, and more equal distribution of wealth between producers, remains relevant today (West, n.d.). Yet, large companies still seek advantages in trade and work to put competitors out of business. It is important to maintain unrestrained trade and prevent the few from having too much power over the many.

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15.3: Antitrust Laws

Antitrust legislation was designed to prevent unfair restrictions on trade and to maintain equal opportunity for trade for businesses and consumers alike. Throughout the history of antitrust laws, legislation has become more comprehensive and structured to keep up with the business practices of larger corporations that continue to seek advantages and control through trade practices.

What Do Antitrust Laws Do?

Antitrust laws were created to prevent unlawful mergers and business practices that could lead to restraint of trade by others (Federal Trade Commission, n.d.). The laws themselves are somewhat general to allow the courts the ability to make decisions on these practices, based on changing times and markets (Federal Trade Commission, n.d.). The three main antitrust laws that are in effect have been in effect for over 100 years and through many changes in society—from an industrial age to a technological age, and the changing markets they represent. The federal government created and enforces these three main antitrust laws:

- The Sherman Antitrust Act
- The Clayton Act
- The Federal Trade Commission Act

Each state has its own antitrust laws that pertain to trade practices within each separate state, but federal laws are able to reach beyond the states to interstate trade.

The Sherman Antitrust Act

The Sherman Act was passed in 1890 and focused on trade restraints that were considered unreasonable (Federal Trade Commission, n.d.). This Act did not prohibit all forms of trade restraint, since the courts did not see temporary limited restraints as an issue at the time. A partnership agreement that limited trade to certain areas for certain partners was considered acceptable. The courts deemed some trade restrictions as unreasonable, such as price fixing (Federal Trade Commission, n.d.). In some cases, the violation was so apparent that the violation was considered **prima facie**, or so evident that it automatically satisfied the unreasonable standard (Jurist, 2013).

The Sherman Act prohibits all contracts and interactions that unreasonably restrain foreign trade and trade between states (United States Department of Justice, n.d.). This prohibition does not mean that companies cannot lower prices on goods in an effort to outsell the competition. Doing so would be considered fair competition and trade. However, when a company is able to suppress the ability of others to compete through some intentional unfair business practice, such as forming agreements with competitors to set prices, it is considered a violation.

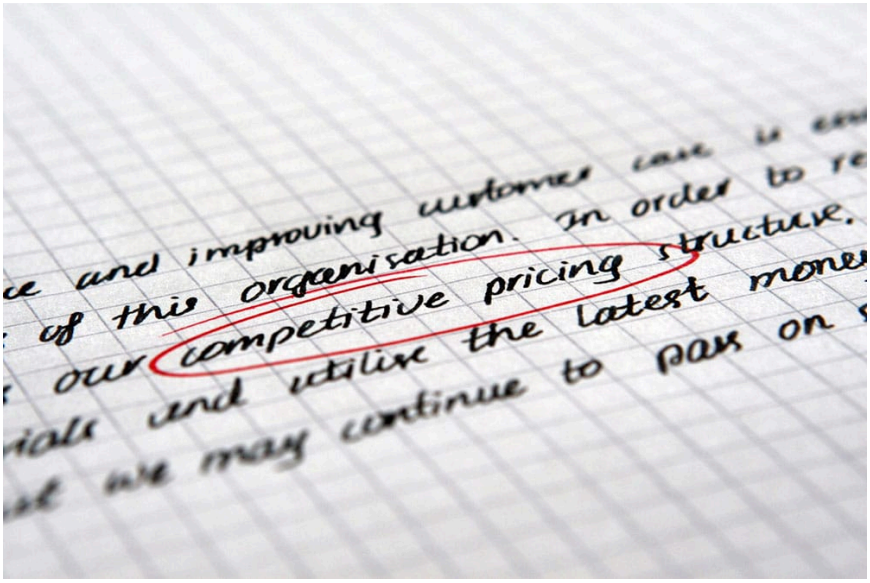


Figure 15.3.1: Competitive pricing is a normal part of business until it involves unfair trade practices. (Credit: pixabay/ pexels/ CC0)

The Act is a criminal statute, meaning that violation of this Act would result in criminal penalties. Mergers or other actions that would create agreements to fix prices or bids or allocate customers are considered criminal felonies (The United States Department of Justice, n.d.). Violations of the Sherman Act could lead to penalties of up to $100 million for larger corporations and up to $1 million for individuals (Federal Trade Commission, n.d.). Those convicted could also face up to 10 years in prison. If the amount gained by the conspirators, or the amount lost by the victims of the crime, is over $100 million, the fine could be increased to twice the amount gained by the conspirators or lost by the victims—whichever is greater (Federal Trade Commission, n.d.).

The Sherman Act did have limitations. It did not provide clear and specific language, which left the courts to make decisions on a case-by-case basis, without any consistent **precedent** on which to rely (West, n.d.). Precedent occurs as courts make rulings in certain cases, and those rulings are followed in subsequent cases. This lack of precedent left many larger companies in control of their restraint of trade practices, and new legislation seemed necessary.

The Clayton Act

The Clayton Act was passed in 1914. The Clayton Act is a civil statute rather than a criminal statute, meaning that it carries civil penalties rather than prison sentences (United States Department of Justice, n.d.). It primarily focuses on unfair mergers and acquisitions (Jurist, 2013). This Act sought to create more specific language to help the courts reduce unfair trade practices. As such, it established four acts as illegal, but not criminal, meaning that they would be tried as civil matters. The four acts are (West, n.d.):

- Price discrimination, which occurs as the same product is sold to different buyers at different prices
- Exclusive dealing contracts, which require buyers to purchase only from one business and not competitors
- Corporate mergers, which result in the acquisition of competing companies
- Interlocking directorates, which are boards of competing companies with common members sitting on each of the boards

The four acts would only be considered illegal when they create monopolies or substantially lessen competition (West, n.d.). Unions were excluded from mention in the Clayton Act, as Congress did not wish to treat human labor as a commodity (West, n.d.). This Act was still broad enough to rely on the courts for interpretation and decisions on a case-by-case basis.

The Clayton Act was amended in 1976 to require companies planning larger mergers and acquisitions to notify the government in advance and seek authorization (Federal Trade Commission, n.d.). This amendment also provides individuals who are victims of these practices with the ability to sue for triple damages after harm is established (Federal Trade Commission, n.d.).

The Federal Trade Commission Act

The Federal Trade Commission Act (FTC Act), also passed in 1914, focuses on unfair methods of competition and deceptive acts or practices that impact commerce (West, n.d.). All acts that violate the Sherman Act also violate the FTC Act (Federal Trade Commission, n.d.). The FTC Act works to fill in the gaps of the unfair practices by condemning all anticompetitive behaviors not otherwise covered in the other federal antitrust laws (West, n.d.).



Figure 15.3.2: The Federal Trade Commission was created to oversee fair trade practices. (Credit: Clker-Free-Vector-Images/ pixabay/ License: CC0)

The FTC Act is only enforceable by the Federal Trade Commission (FTC), which was created as a result of this Act (Jurist, 2013). The FTC implements the Act's provisions, and the FTC and the U.S. Department of Justice (DOJ) are the federal agencies responsible for prosecuting violators in either civil or criminal proceedings, depending on the act violated. One remedy that the FTC or DOJ can seek is divestiture, which forces the company to give up one or more of its operating functions (West, n.d.). Another remedy is **dissolution**, which would terminate the right of a partnership to exist (West, n.d.).

Exemptions

There are limitations on antitrust laws that have been introduced over the years. These include:

- Labor – A labor union can organize and bargain within the bounds of antitrust laws, as long as it does not combine with a nonlabor group.
- Agriculture and Fisheries – Collective co-ops of agricultural groups or fisheries can form, as long as they do not engage in restraint of trade.
- Foreign Trade – Companies can join forces in cooperative activities involving foreign trade exports, as long as trade within the United States is not restrained.
- Cooperative Research and Production – Small businesses can cooperatively work together on research joint ventures.

In essence, exemptions are allowed, as long as they do not act to restrain trade in the United States (West, n.d.). Once restraint of trade becomes a factor, the practices are no longer exemptions and are subject to antitrust laws.

Conclusion

The three main antitrust laws, namely the Sherman Act, the Clayton Act, and the Federal Trade Commission Act, all work to prevent unfair trade practices that can substantially harm free competition. They also work to protect consumers from practices that would control pricing or the ability to buy or engage in services. They prevent companies from taking actions that would allow them to become too big or too powerful, thus controlling how, and what, consumers and other businesses can do.

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15.4: End Notes

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15.5: Assessment Questions

1. All of the following are forms of restraint of trade that company might use to reduce competition except:
   a. Monopolies.
   b. Oversupply.
   c. Price-fixing.
   d. Mergers.

   Answer

   b

2. What is a Business Trust?
3. Distinguish between naked restraint and ancillary restraint.

   Answer

   Naked restraint occurs as contracts promote a general restraint of competition. If the restraint was created with a goal of long-term impact without boundaries, it was considered to be a naked restraint. Ancillary restraint occurs as the restriction is limited in time and geography. With ancillary restraint, the restraint would be short-term and limited in scope. The courts tended to frown upon naked restraint, but were less consistent with ancillary restraint.

4. What was the first antitrust law enacted?.
   a. The Clayton Act.
   b. The Federal Trade Commission Act.
   c. The Antitrust Act.
   d. The Sherman Act.
5. What was the original purpose of antitrust legislation?

   Answer

   The original purpose of antitrust legislation, i.e., to foster competition that results in lower prices, more products, and more equal distribution of wealth between producers, remains relevant today.

6. What recourse does the FTC have if an individual or company engages in an unfair trade practice?
   a. Consent order.
   b. Administrative complaint.
   c. Litigation.
   d. All of the above.
7. Each state has its own Antitrust law.
   a. True.
   b. False.

   Answer

   b

8. Which of the following is not prohibited by the Sherman Act?
   a. Temporary limited restraints.
   b. Temporary restraints.
   c. Naked restraints.
   d. Ancillary restraints.
9. Which of the following are possible penalties for violation of the Sherman Act?
   a. Up to $\$100$ million for corporations and individuals.
   b. Up to $\$100$ million for individuals.
   c. Up to $\$100$ millions for corporations.
   d. None of these are correct.

Answer

c

10. Which of the following are considered illegal by the Clayton Act?
    a. Price discrimination.
    b. Exclusive dealing contracts.
    c. Corporate mergers.
    d. All of the above.
11. The following are exempt from antitrust laws:
    a. Small businesses.
    b. Coops.
    c. Labor unions.
    d. Agriculture groups even if they engage in restraint of trade.

Answer

c

12. When was the Federal Trade Commission established?
    a. 1912.
    b. 1914.
    c. 1916.
    d. 1920.
13. The following are bureaus of the Federal Trade Commission except:
    a. Bureau of Unfair Trade Practices.
    b. Bureau of Consumer Protection.
    c. Bureau of Competition.
    d. Bureau Economics.

Answer

a

14. What is the mission of the Bureau of Competition?
15. Explain the Wheeler-Lea Act.

Answer

The FTC did not formally have a consumer protection mission until the passage of the Wheeler-Lea Act in 1938. This act gave the FTC the power to combat false advertising for any foods, drugs, medical devices, or cosmetics. In addition to the Wheeler-Lea Act, subsequent amendments to the FTC Act, as well as judicial respect toward the agency, broadened the power and jurisdiction of the FTC.

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16: BANKRUPTCY

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16.1: Chapter Introduction

Learning Objectives

After reading this chapter, you should understand the following:

1. A short history of US bankruptcy law
2. An overview of key provisions of the 2005 bankruptcy act
3. The basic operation of Chapter 7 bankruptcy
4. The basic operation of Chapter 11 bankruptcy
5. The basic operation of Chapter 13 bankruptcy
6. What debtor's relief is available outside of bankruptcy

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16.2: Introductin to Bankruptcy and Overview of the 2005 Bankruptcy Act

Learning Objectives

1. Understand what law governs bankruptcy in the United States.
2. 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.

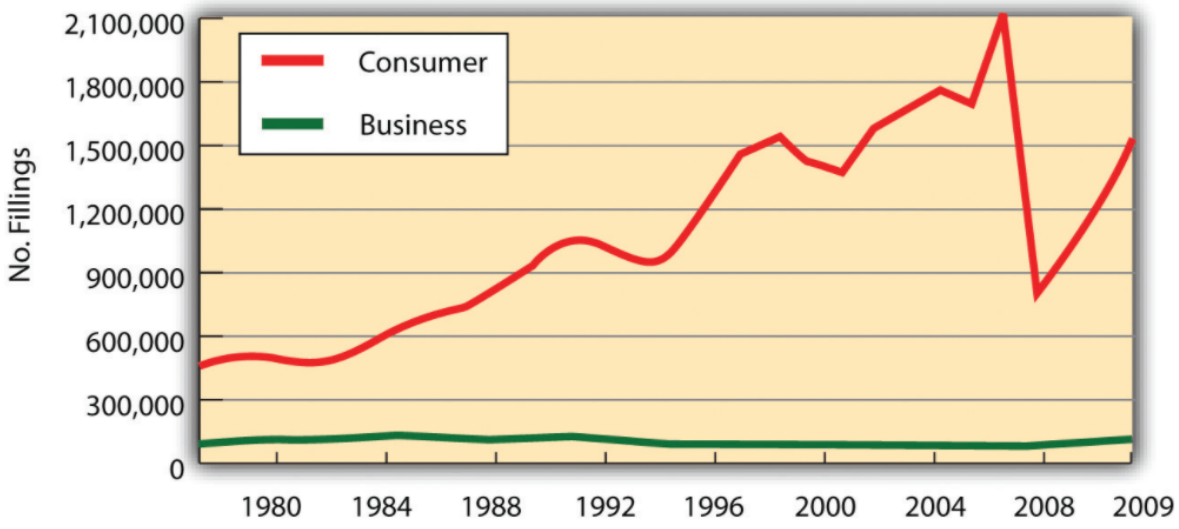
Bankruptcy Statutes

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 35.1 "US Bankruptcies, 1980–2009"). 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, http://www.cch.com/bankruptcy/bankruptcy_04-21.pdf.—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 35.1 US Bankruptcies, 1980–2009



Bankruptcy Action.com, www.bankruptcyaction.com/USbankstats.htm, statistics from Administrative Office of the Courts.

Bankruptcy Courts, Judges, and Costs

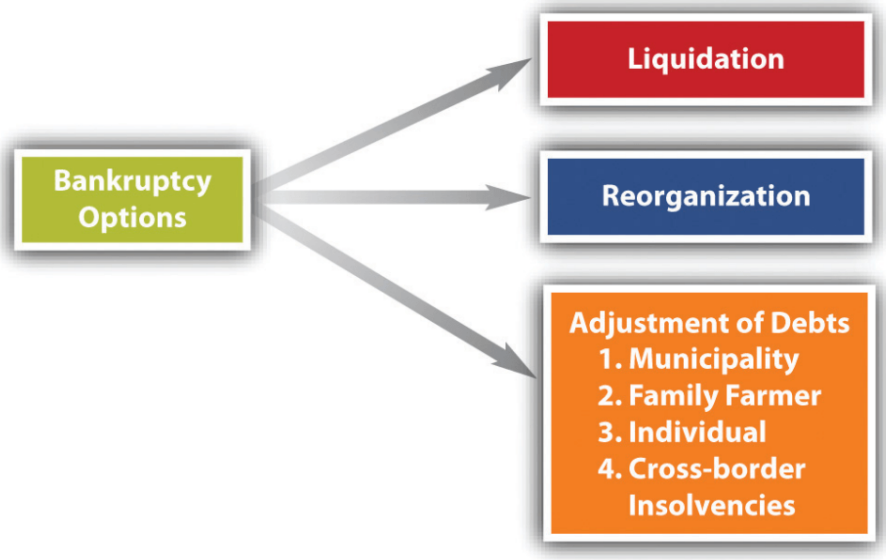
Each federal judicial district has a US Bankruptcy Court, whose judges are appointed by US Courts of Appeal. Unless both sides agree otherwise, bankruptcy judges are to hear only bankruptcy matters (called core proceedings). Bankruptcy trustees are government lawyers appointed by the US Attorney General. They have administrative responsibilities in overseeing the proceedings.

The filing fee for a bankruptcy is about $200, depending upon the type of bankruptcy, and the typical lawyer's fee for uncomplicated cases is about $1,200–$1,400.

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 35.2 "Bankruptcy Options").

Figure 35.2 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:

- 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 35.5 "Alternatives to Bankruptcy", "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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16.3: Case Administration; Creditors' Claims; Debtors' Exemptions and Dischargeable Debts; Debtor's Estate

Learning Objectives

1. Understand the basic procedures involved in administering a bankruptcy case.
2. Recognize the basic elements of creditors' rights under the bankruptcy code.
3. Understand the fundamentals of what property is included in the debtor's estate.
4. Identify some of the debtor's exemptions—what property can be kept by the debtor.
5. Know some of the debts that cannot be discharged in bankruptcy.
6. 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. To put anyone into bankruptcy involuntarily, the petitioning creditors must meet three conditions: (1) they must have claims for unsecured debt amounting to at least $13,475; (2) three creditors must join in the petition whenever twelve or more creditors have claims against the particular debtor—otherwise, one creditor may file an involuntary petition, as long as his claim is for at least $13,475; (3) there must be no bona fide dispute about the debt owing. If there is a dispute, the debtor can resist the involuntary filing, and if she wins the dispute, the creditors who pushed for the involuntary petition have to pay the associated costs. Persons owing less than $13,475, farmers, and charitable organizations cannot be forced into bankruptcy.

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 35.3 "Chapter 7 Liquidation".

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 (as discussed in Chapter 33 "Secured Transactions and Suretyship" and Chapter 34 "Mortgages and Nonconsensual Liens"). 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 35.3 "Distribution of the Estate"), 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 35.3 "Chapter 7 Liquidation".

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 35.6 "Cases", *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 35.3 "Chapter 7 Liquidation", 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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16.4: Chapter 7 Liquidation

Learning Objectives

1. Recognize the grounds for a Chapter 7 case to be dismissed.
2. Be familiar with the BAPCPA's means-testing requirements before Chapter 7 discharge is granted.
3. Know under what circumstances a debtor will be denied discharge.
4. 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/...10th/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 35.3 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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16.5: Chapter 11 and Chapter 13 Bankruptcies

Learning Objectives

1. Understand the basic concepts of Chapter 11 bankruptcies.
2. 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 35.2 "Case Administration; Creditors' Claims; Debtors' Exemptions and Dischargeable Debts; Debtor's Estate", 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 $336,000, and secured debts of less than $1,010,650 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 35.6 "Cases", *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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16.6: Alternatives to Bankruptcy

Learning Objectives

1. 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.
2. 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

Assignment for 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

A **composition** 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, composition 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 composition lies in the creditors' agreement: an assignment implies no agreement among the creditors, whereas a composition does. Not all creditors of the particular debtor need agree to the composition for it to be valid. A creditor who does not agree to the composition 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 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 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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16.7: Cases

Dischargeability of Student Loans under Chapter 7

In re Zygarewicz

423 B.R. 909 (Bkrtcy.E.D.Cal. 2010)

MCMANUS, BANKRUPTCY JUDGE.

Angela Zygarewicz, a chapter 7 debtor and the plaintiff in this adversary proceeding, borrowed 16 government-guaranteed student [sic] loans totaling $81,429. The loans have been assigned to Educational Credit Management Corporation ("ECMC"). By September 2009, the accrual of interest on these student loans had caused the debt to balloon to more than $146,000. The debtor asks the court to declare that these student loans were discharged in bankruptcy.

The Bankruptcy Code provides financially distressed debtors with a fresh start by discharging most of their pre-petition debts....However, under 11 U.S.C. § 523(a)(8), there is a presumption that educational loans extended by or with the aid of a governmental unit or nonprofit institution are nondischargeable unless the debtor can demonstrate that their repayment would be an undue hardship. See [Citation]. This exception to a bankruptcy discharge ensures that student loans, which are typically extended solely on the basis of the student's future earnings potential, cannot be discharged by recent graduates who then pocket all of the future benefits derived from their education. See [Citation].

The debtor bears the burden of proving by a preponderance of the evidence that she is entitled to a discharge of the student loan. See [Citation]. That is, the debtor must prove that repayment of student loans will cause an undue hardship.

The Bankruptcy Code does not define "the undue hardship." Courts interpreting section 523(a)(8), however, have concluded that undue hardship [and] is something more than "garden-variety hardship." [Citation.] Only cases involving "real and substantial" hardship merit discharges. See [Citation.]

The Ninth Circuit has adopted a three-part test to guide courts in their attempts to determine whether a debtor will suffer an undue hardship is required to repay a student loan:

- First, the debtor must establish "that she cannot maintain, based on current income and expenses, a 'minimal' standard of living for herself and her dependents if forced to repay the loans."...
- Second, the debtor must show "that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans."...
- The third prong requires "that the debtor has made good faith efforts to repay the loans...."

(*Pena,* citing *Brunner v. N.Y. State Higher Educ. Servs. Corp.*, [Citation]).

Debtor must satisfy all three parts of the *Brunner* test before her student loans can be discharged. Failure to prove any of the three prongs will defeat a debtor's case.

When this bankruptcy case was filed in September 2005, the debtor was a single woman and had no dependents. She is 39 years old.

Schedule I reported that the debtor was unemployed. The debtor's responses to the Statement of Financial Affairs revealed that she had received $5,500 in income during 2005 prior to the filing of the petition. Evidence at trial indicated that after the petition was filed, the debtor found work and earned a total of $9,424 in 2005. In 2004 and 2003, she earned $13,994 and $17,339, respectively.

Despite this modest income, the debtor did not immediately file an adversary proceeding to determine the dischargeability of her student loans. It was almost three years after the entry of her chapter 7 discharge 'on January 3, 2006 that the debtor reopened her chapter 7 case in order to pursue this adversary proceeding.'

In her complaint, the debtor admits that after she received a discharge, she found part-time work with a church and later took a

full-time job as a speech therapist. During 2006, the debtor earned $20,009 and in 2007 she earned $37,314. Hence, while it is clear the debtor's income was very modest in the time period immediately prior to her bankruptcy petition, her financial situation improved during her bankruptcy case.

The court cannot conclude based on the evidence of the debtor's financial circumstances up to the date of the discharge, that she was unable to maintain a minimal standard of living if she was required to repay her students [sic] loans.

However, in January 2007, the debtor was injured in an automobile accident. Her injuries eventually halted the financial progress she had been making and eventually prevented her from working. She now subsists on social security disability payments.

The circumstance creating the debtor's hardship, the automobile accident, occurred after her chapter 7 petition was filed, indeed, approximately one year after her discharge was entered. The debtor is maintaining that this post-petition, post-discharge circumstance warrants a declaration that her student loans were discharged effective from the petition date.

When must the circumstances creating a debtor's hardship arise: before the bankruptcy case is filed; after the case if filed but prior to the entry of a discharge; or at anytime, including after the entry of a discharge?

The court concludes that the circumstances causing a chapter 7 debtor's financial hardship must arise prior to the entry of the discharge. If the circumstances causing a debtor's hardship arise after the entry of a discharge, those circumstances cannot form the basis of a determination that repayment of a student loan will be an undue hardship....

[T]here is nothing in the Bankruptcy Code requiring that a complaint under section 523(a)(8) [to discharge student loans] be filed at any particular point in a bankruptcy case, whether it is filed under chapter 7 or 13. [Relevant Federal Rules of Bankruptcy Procedure] permits such dischargeability complaints to be brought at any time, including after the entry of a discharge and the closing of the bankruptcy case....

While a debtor's decision to file an action to determine the dischargeability of a student loan is not temporally constrained, this does not mean that a debtor's financial hardship may arise after a discharge has been entered.

[The] *Coleman* [case, cited by debtor] deals with the ripeness of a dispute concerning the dischargeability of a student loan. [The Ninth Circuit held that it] is ripe for adjudication at any point during the case. The Ninth Circuit did not conclude, however, that a debtor could rely upon post-discharge circumstances to establish undue hardship. In fact, the court in *Coleman* made clear that the debtor could take a snapshot of the hardship warranting a discharge of a student loan any time *prior* to discharge. [*Coleman* was a Chapter 13 case.]

Here, the debtor was injured in an automobile accident on January 17, 2007, almost exactly one year after her January 3, 2006 chapter 7 discharge. Because the accident had no causal link to the misfortune prompting the debtor to seek bankruptcy relief in the first instance, the accident cannot be relied on to justify the discharge of the student loans because repayment would be an undue hardship.

To hold otherwise would mean that a bankruptcy discharge is a perpetual license to discharge student loans based on events that occur years after the bankruptcy discharge is granted. If a discharged debtor suffers later financial misfortune, that debtor must consider seeking another discharge subject to the limitations imposed by [the sections of the code stipulating how often a person can petition for bankruptcy]. In the context of a second case, the debtor could then ask that the student loan be declared dischargeable under section 523(a)(8).

In this instance, the debtor is now eligible for a discharge in a chapter 13 case. Her chapter 7 petition was filed on September 19, 2005. Section 1328(f)(1) bars a chapter 13 discharge when the debtor has received a chapter 7 discharge in a case commenced in the prior four years. She would not be eligible for a chapter 7 discharge until September 19, 2013.

This is not to say that post-discharge events are irrelevant. The second and third prongs of the *Pena* test require the court to consider whether the circumstances preventing a debtor from repaying a student loan are likely to persist, and whether the debtor has made good faith efforts to repay the student loan. Post-discharge events are relevant to these determinations because they require the court to look into the debtor's financial future.

Unfortunately for the debtor, it is unnecessary to consider the second and third prongs because she cannot satisfy the first prong.

CASE QUESTIONS

1. What is the rationale for making the bankruptcy discharge of student loans very difficult?
2. Petitioner argued that she should be able to use a postdischarge event (the auto accident) as a basis for establishing that she could not maintain a "minimal" standard of living, and thus she should get a retroactive discharge of her student loans. What benefit is there to her if she could successfully make the argument, given that she could—as the court noted—file for Chapter 13?
3. The court cites the *Coleman* case. That was a Chapter 13 proceeding. Here were the facts: Debtor had not yet completed her payments under her five-year repayment plan, and no discharge order had yet been entered; one year into the plan, she was laid off work. She had been trying to repay her student loans for several years, and she claimed she would suffer hardship in committing to the five-year repayment plan without any guarantee that her student loan obligations would be discharged, since she was required to commit all of her disposable income to payments under the plan and would likely be forced to pursue undue hardship issue pro se upon completion of the plan." In *Coleman,* the court held that Debtor could, postfiling but predischarge—one year into the five-year plan—bring up the hardship issue.

   Now, in the case here, after the auto accident, the petitioner "subsists" on Social Security disability payments, and she has almost $150,000 in debt, yet the court prohibited her from claiming a hardship discharge of student loans. Does this result really make sense? Is the court's concern that allowing this postdischarge relief would mean "that a bankruptcy discharge is a perpetual license to discharge student loans based on events that occur years after the bankruptcy discharge is granted" well founded? Suppose it is scheduled to take thirty years to pay off student loans; in year 4, the student-borrower, now Debtor, declares Chapter 7 bankruptcy, student loans not being discharged; in year 6, the person is rendered disabled. What public policy is offended if the person is allowed to "reopen" the bankruptcy and use the postbankruptcy event as a basis for claiming a hardship discharge of student loans?

4. The court suggests she file for Chapter 13. What if—because of timing—the petitioner was not eligible for Chapter 13? What would happen then?

Chapter 11 Bankruptcy

In re Johns-Manville Corp.

36 B.R. 727 (Bkrtcy. N.Y. 1984)

Lifland, Bankruptcy Judge.

Whether an industrial enterprise in the United States is highly successful is often gauged by its "membership" in what has come to be known as the "Fortune 500". Having attained this measure of financial achievement, Johns-Manville Corp. and its affiliated companies (collectively referred to as "Manville") were deemed a paradigm of success in corporate America by the financial community. Thus, Manville's filing for protection under Chapter 11 of Title 11 of the United States Code ("the Code or the Bankruptcy Code") on August 26, 1982 ("the filing date") was greeted with great surprise and consternation on the part of some of its creditors and other corporations that were being sued along with Manville for injuries caused by asbestos exposure. As discussed at length herein, Manville submits that the sole factor necessitating its filing is the mammoth problem of uncontrolled proliferation of asbestos health suits brought against it because of its substantial use for many years of products containing asbestos which injured those who came into contact with the dust of this lethal substance. According to Manville, this current problem of approximately 16,000 lawsuits pending as of the filing date is compounded by the crushing economic burden to be suffered by Manville over the next 20–30 years by the filing of an even more staggering number of suits by those who had been exposed but who will not manifest the asbestos-related diseases until some time during this future period ("the future asbestos claimants"). Indeed, approximately 6,000 asbestos health claims are estimated to have arisen in only the first 16 months since the filing date. This burden is further compounded by the insurance industry's general disavowal of liability to Manville on policies written for this very purpose.

It is the propriety of the filing by Manville which is the subject of the instant decision. Four separate motions to dismiss the petition pursuant to Section 1112(b) of the Code have been lodged before this Court....

Preliminarily, it must be stated that there is no question that Manville is eligible to be a debtor under the Code's statutory requirements. Moreover, it should also be noted that neither Section 109 nor any other provision relating to voluntary petitions by companies contains any insolvency requirement....Accordingly, it is abundantly clear that Manville has met all of the threshold eligibility requirements for filing a voluntary petition under the Code....

A “principal goal” of the Bankruptcy Code is to provide “open access” to the “bankruptcy process.” [Citation.] The rationale behind this “open access” policy is to provide access to bankruptcy relief which is as “open” as “access to the credit economy.” Thus, Congress intended that “there should be no legal barrier to voluntary petitions.” Another major goal of the Code, that of “rehabilitation of debtors,” requires that relief for debtors must be “timely.” Congress declared that it is essential to both the “open access” and “rehabilitation” goals that

[i]nitiating relief should not be a death knell. The process should encourage resort to it, by debtors and creditors, that cuts short the dissipation of assets and the accumulation of debts. Belated commencement of a case may kill an opportunity for reorganization or arrangement.

Accordingly, the drafters of the Code envisioned that a financially beleaguered debtor with real debt and real creditors should not be required to wait until the economic situation is beyond repair in order to file a reorganization petition. The “Congressional purpose” in enacting the Code was to encourage resort to the bankruptcy process. This philosophy not only comports with the elimination of an insolvency requirement, but also is a corollary of the key aim of Chapter 11 of the Code, that of avoidance of liquidation. The drafters of the Code announced this goal, declaring that reorganization is more efficient than liquidation because “assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.” [Citation.] Moreover, reorganization also fosters the goals of preservation of jobs in the threatened entity. [Citation.]

In the instant case, not only would liquidation be wasteful and inefficient in destroying the utility of valuable assets of the companies as well as jobs, but, more importantly, liquidation would preclude just compensation of some present asbestos victims and all future asbestos claimants. This unassailable reality represents all the more reason for this Court to adhere to this basic potential liquidation avoidance aim of Chapter 11 and deny the motions to dismiss. Manville must not be required to wait until its economic picture has deteriorated beyond salvation to file for reorganization.

Clearly, none of the justifications for declaring an abuse of the jurisdiction of the bankruptcy court announced by these courts [in various cases cited] are present in the *Manville* case. In *Manville,* it is undeniable that there has been no sham or hoax perpetrated on the Court in that Manville is a real business with real creditors in pressing need of economic reorganization. Indeed, the Asbestos Committee has belied its own contention that Manville has no debt and no real creditors by quantifying a benchmark settlement demand approaching one billion dollars for compensation of approximately 15,500 pre-petition asbestos claimants, during the course of negotiations pitched toward achieving a consensual plan. This huge asserted liability does not even take into account the estimated 6,000 new asbestos health claims which have arisen in only the first 16 months since the filing date. The number of post-filing claims increases each day as “future claims back into the present.” ...

In short, Manville’s filing did not in the appropriate sense abuse the jurisdiction of this Court and it is indeed, like the debtor in [Citation], a “once viable business supporting employees and unsecured creditors [that] has more recently been burdened with judgments [and suits] that threaten to put it out of existence.” Thus, its petition must be sustained....

In sum, Manville is a financially besieged enterprise in desperate need of reorganization of its crushing real debt, both present and future. The reorganization provisions of the Code were drafted with the aim of liquidation avoidance by great access to Chapter 11. Accordingly, Manville’s filing does not abuse the jurisdictional integrity of this Court, but rather presents the same kinds of reasons that were present in [Citation], for awaiting the determination of Manville’s good faith until it is considered...as a prerequisite to confirmation or as a part of the cadre of motions before me which are scheduled to be heard subsequently.

[A]ll four of the motions to dismiss the Manville petition are denied in their entirety.

CASE QUESTIONS

1. What did Manville want to do here, and why?
2. How does this case demonstrate the fundamental purpose of Chapter 11 as opposed to Chapter 7 filings?
3. The historical background here is that Manville knew from at least 1930 that asbestos—used in many industrial applications—was a deadly carcinogen, and it worked diligently for decades to conceal and obfuscate the fact. What “good faith” argument was raised by the movants in this case?

Chapter 13: What Debts Are Dischargeable?

In re Ryan

389 B.R. 710 9th Cir. BAP, (Idaho, 2008)

On July 13, 1995, Ryan was convicted of possession of an unregistered firearm under 26 U.S.C. § 5861(d) in the United States District Court for the District of Alaska. Ryan was sentenced to fifty-seven months in prison followed by three years of supervised release. In addition, Ryan was ordered to pay a fine of $7,500..., costs of prosecution in the amount of $83,420, and a special assessment of $50.00. Ryan served his sentence. He also paid the $7,500 fine. The district court, following an appellate mandate, ultimately eliminated the restitution obligation.

On April 25, 2003, Ryan filed a petition for bankruptcy relief under chapter 7 in the District of Idaho. He received his chapter 7 discharge on August 11, 2003. Shortly thereafter, Ryan filed a case under chapter 13, listing as his only obligation the amount of unpaid costs of prosecution owed to the United States ("Government")....

Ryan completed payments under the plan, and an "Order of Discharge" was entered on October 5, 2006. The chapter 13 trustee's final report reflected that the Government received $2,774.89 from payments made by Ryan under his plan, but a balance of $77,088.34 on the Government's costs of prosecution claim remained unpaid. Ryan then renewed his request for determination of dischargeability. The bankruptcy court held that the unpaid portion of the Government's claim for costs of prosecution was excepted from discharge by § 1328(a)(3). Ryan appealed.

Section 1328(a)(3) provides an exception to discharge in chapter 13 for "restitution, or a criminal fine." It states, in pertinent part:

[A]s soon as practicable after the completion by the debtor of all payments under the plan, the court shall grant the debtor a discharge of all debts provided for by the plan or disallowed under section 502 of this title except any debt...

(3) for restitution, or a *criminal fine,* included in a sentence on the debtor's conviction of a crime [.] [emphasis added].

The essential question, then, is whether these costs of prosecution constitute a "criminal fine."

Statutory interpretation begins with a review of the particular language used by Congress in the relevant version of the law. [Citation.]

The term "criminal fine" is not defined in [Chapter 13] or anywhere else in the Bankruptcy Code. However, its use in § 1328(a)(3) implicates two important policies embedded in the Bankruptcy Code. First, in light of the objective to provide a fresh start for debtors overburdened by debts that they cannot pay, exceptions to discharge are interpreted strictly against objecting creditors and in favor of debtors. *See, e.g.* [Citations]. In chapter 13, this principle is particularly important because Congress adopted the liberal "superdischarge" provisions of § 1328 as an incentive to debtors to commit to a plan to pay their creditors all of their disposable income over a period of years rather than simply discharging their debts in a chapter 7 liquidation.

"[T]he dischargeability of debts in chapter 13 that are not dischargeable in chapter 7 represents a policy judgment that [it] is preferable for debtors to attempt to pay such debts to the best of their abilities over three years rather than for those debtors to have those debts hanging over their heads indefinitely, perhaps for the rest of their lives." [Citations.]

A second, countervailing policy consideration is a historic deference, both in the Bankruptcy Code and in the administration of prior bankruptcy law, to excepting criminal sanctions from discharge in bankruptcy. Application of this policy is consistent with a general recognition that, "[t]he principal purpose of the Bankruptcy Code is to grant a 'fresh start' to the '*honest* but unfortunate debtor.'" [Citation] (emphasis added [in original]).

The legislative history is clear that [in its 1994 amendments to the bankruptcy law] Congress intended to overrule the result in [of a 1990 Supreme Court case so that]:..."[N]o debtor with criminal restitution obligations will be able to discharge them through any bankruptcy proceeding."...

The imposition on a defendant of the costs of a special prosecutor is different from ordering a defendant to pay criminal fines. Costs are paid to the entity incurring the costs; criminal fines are generally paid to a special fund for victims' compensation and assistance in the U.S. Treasury....

To honor the principle that exceptions to discharge are to be construed narrowly in favor of debtors, particularly in chapter 13, where a broad discharge was provided by Congress as an incentive for debtors to opt for relief under that chapter rather than under chapter 7, it is not appropriate to expand the scope of the [Chapter 13] exception beyond the terms of the statute. Congress could have adopted an exception to discharge in chapter 13 that mirrored [the one in Chapter 7]. It did not do so. In contrast, under [the 2005] BAPCPA, when Congress wanted to limit the chapter 13 "superdischarge," it incorporated exceptions to discharge from [Chapter 7] wholesale....

As a bottom line matter, Ryan served his time and paid in full the criminal fine that was imposed as part of his sentence for

conviction of possession of an unregistered firearm. The restitution obligation that was included as part of his sentence was voided. Ryan paid the Government a total of $6,331.66 to be applied to the costs of prosecution awarded as part of his criminal judgment, including $2,774.89 paid under his chapter 13 plan, leaving a balance of $77,088.34. We determine that the unpaid balance of the costs of prosecution award was covered by Ryan's chapter 13 discharge.

Based on the foregoing analysis, we conclude that the exception to discharge included in [Chapter 13] for "restitution, or a criminal fine, included in a sentence on the debtor's conviction of a crime" does not cover costs of prosecution included in such a sentence, and we REVERSE.

CASE QUESTIONS

1. What is the rationale for making some things dischargeable under Chapter 13 that are not dischargeable under Chapter 7?
2. What is the difference between "criminal restitution" (which in 1994 Congress said could not get discharged at all) and "the costs of prosecution"?
3. Why did the court decide that Ryan's obligation to pay "costs of prosecution" was not precluded by the limits on Chapter 13 bankruptcies imposed by Congress?

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16.8: 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?

SELF-TEST QUESTIONS

1. Alternatives to bankruptcy include a. an assignment
   b. a composition
   c. receivership
   d. all of the above
2. A composition is a. a procedure where a receiver takes over the debtor's property
   b. an agreement by creditors to take less than the face value of their debt
   c. basically the same as an assignment
   d. none of these
3. The highest-priority class set out by the 2005 act is for a. employees' wages
   b. administrative expenses
   c. property settlements arising from divorce
   d.domestic support obligations
4. Darlene Debtor did the following within ninety days of filing for bankruptcy. Which could be set aside as a preferential payment? a. paid water and electricity bills
   b. made a gift to the Humane Society
   c. prepaid an installment loan on inventory
   d. borrowed money from a bank secured by a mortgage on business property
5. Donald Debtor sold his 1957 Chevrolet to his brother for one-fifth its value sixty days before filing for bankruptcy. The trustee wishes to avoid the transaction on the basis that it was a. a hypothetical lien
   b. a lease disguised as a sale
   c. a preferential payment
   d.a voidable preference
6. Acme Co. filed for bankruptcy with the following debts; which is their correct priority from highest to lowest?

   i. wages of $15,000 owed to employees

   ii. unpaid federal taxes

   iii. balance owed to a creditor who claimed its security with a $5,000 deficiency owing

a. i, ii, iii
b. ii, iii, i
c. iii, ii, i
d. i, iii, ii

SELF-TEST AnswerS

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

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16.9.1: Chapter Introduction

Learning Objectives

After reading this chapter, you should understand the following:

1. The difference between personal property and other types of property
2. How rights in personal property are acquired and maintained
3. How some kinds 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. In Chapter 18 "Intellectual Property", we discuss intellectual property, a kind of personal property that is increasingly profitable.

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16.9.2: The General Nature of Property Rights

Learning Objectives

1. Understand the elastic and evolving boundaries of what the law recognizes as property that can be bought or sold on the market.
2. 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 even fifteen 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 36.3 "Fixtures" 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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16.9.3: Personal Property

Learning Objectives

1. 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 36.2.2 "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 36.4.1 "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 36.4.1 "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

Figure 36.1 Gift 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* (see Figure 36.1 "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.

Gift Tax

The federal government and many states impose gift taxes on gifts above a certain dollar amount.

Accession

An **accession** is something that is added to what one already possesses. In general, the rule is that the owner of the thing owns the additional thing that comes to be attached to it. For example, the owner of a cow owns her calves when she gives birth. But

when one person adds value to another person's property, either through labor alone or by adding new materials, the rule must be stated somewhat differently. The general rule is this: when goods are added to goods, the owner of the principal goods becomes the owner of the enhanced product. For example, a garage uses its paint to repaint its customer's automobile. The car owner, not the painter, is the owner of the finished product.

When someone has wrongfully converted—that is, taken as her own—the property of another, the owner may sue for damages, either to recover his property or its value. But a problem arises when the converter has added to the value of that property. In general, the courts hold that when the conversion is willful, the owner is entitled to the full value of the goods as enhanced by the converter. Suppose that a carpenter enters a ten-acre forest that he knows belongs to his neighbor, cuts down one hundred trees, transports them to his shop, and cuts them up into standard lumber, thus increasing their market value. The owner is entitled to this full value, and the carpenter will get nothing for his trouble. Thus the willful converter loses the value of his labor or materials. If, on the other hand, the conversion was innocent, or at most negligent, the rule is somewhat more uncertain. Generally the courts will award the forest owner the value of the standing timber, giving the carpenter the excess attributable to his labor and transportation. A more favorable treatment of the owner is to give her the full value of the lumber as cut, remitting to the carpenter the value of his expenses.

Confusion

In accession, the goods of one owner are transformed into a more valuable commodity or are inextricably united with the goods of another to form a constituent part. Still another type of joining is known as **confusion**, and it occurs when goods of different owners, while maintaining their original form, are commingled. A common example is the intermingling of grain in a silo. But goods that are identifiable as belonging to a particular person—branded cattle, for instance—are not confused, no matter how difficult it may be to separate herds that have been put together.

When the goods are identical, no particular problem of division arises. Assuming that each owner can show how much he has contributed to the confused mass, he is entitled to that quantity, and it does not matter which particular grains or kernels he extracts. So if a person, seeing a container of grain sitting on the side of the road, mistakes it for his own and empties it into a larger container in his truck, the remedy is simply to restore a like quantity to the original owner. When owners of like substances consent to have those substances combined (such as in a grain silo), they are said to be tenants in common, holding a proportional share in the whole.

In the case of willful confusion of goods, many courts hold that the wrongdoer forfeits all his property unless he can identify his particular property. Other courts have modified this harsh rule by shifting the burden of proof to the wrongdoer, leaving it up to him to claim whatever he can establish was his. If he cannot establish what was his, then he will forfeit all. Likewise, when the defendant has confused the goods negligently, without intending to do so, most courts will tend to shift to the defendant the burden of proving how much of the mass belongs to him.

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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16.9.4: Fixtures

Learning Objectives

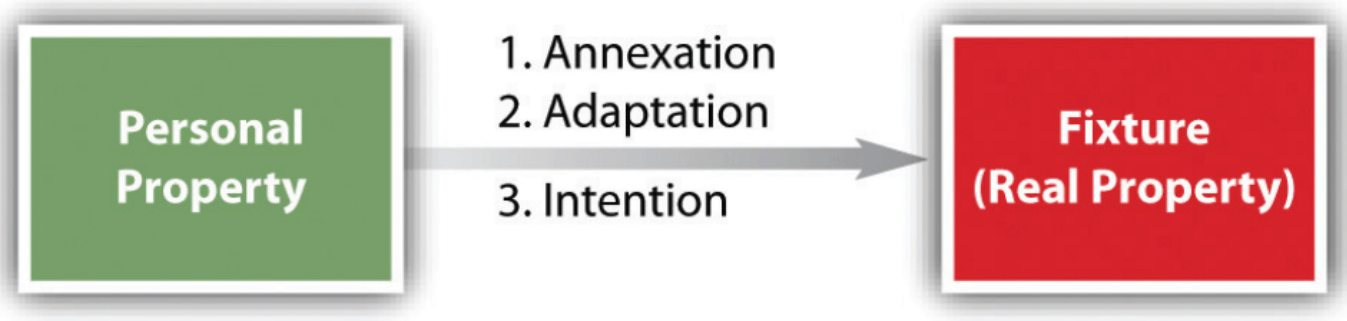
1. Know the three tests for when personal property becomes a fixture and thus becomes real property.

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

Figure 36.2 Fixture 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 (see Figure 36.2 "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 (Chapter 33 "Secured Transactions and Suretyship"). 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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16.9: INTRODUCTION TO PROPERTY- PERSONAL PROPERTY AND FIXTURES

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16.9.5: Case

Lost or Misplaced Property

Bishop v. Ellsworth

91 Ill. App.2d 386, 234 N.E. 2d 50 (1968)

OPINION BY: STOUDER, Presiding Justice

Dwayne Bishop, plaintiff, filed a complaint alleging that on July 21, 1965, defendants, Mark and Jeff Ellsworth and David Gibson, three small boys, entered his salvage yard premises at 427 Mulberry Street in Canton, without his permission, and while there happened upon a bottle partially embedded in the loose earth on top of a landfill, wherein they discovered the sum of $12,590 in US currency. It is further alleged that said boys delivered the money to the municipal chief of police who deposited it with defendant, Canton State Bank. The complaint also alleges defendants caused preliminary notices to be given as required by Ill. Rev. Stats., chapter 50, subsections 27 and 28 (1965), but that such statute or compliance therewith does not affect the rights of the plaintiff. [The trial court dismissed the plaintiff's complaint.]

...It is defendant's contention that the provisions of Ill Rev Stats, chapter 50, subsections 27 and 28 govern this case. The relevant portions of this statute are as follows:

"27. Lost goods...If any person or persons shall hereafter find any lost goods, money, bank notes, or other choses in action, of any description whatever, such person or persons shall inform the owner thereof, if known, and shall make restitution of the same, without any compensation whatever, except the same shall be voluntarily given on the part of the owner. If the owner be unknown, and if such property found is of the value of $ 15 or upwards, the finder...shall, within five days after such finding...appear before some judge or magistrate...and make affidavit of the description thereof, the time and place when and where the same was found, that no alteration has been made in the appearance thereof since the finding of the same, that the owner thereof is unknown to him and that he has not secreted, withheld or disposed of any part thereof. The judge or magistrate shall enter the value of the property found as near as he can ascertain in his estray book together with the affidavit of the finder, and shall also, within ten days after the proceedings have been entered on his estray book, transmit to the county clerk a certified copy thereof, to be by him recorded in his estray book and to file the same in his office...28. Advertisement...If the value thereof exceeds the sum of $ 15, the county clerk, within 20 days after receiving the certified copy of the judge or magistrate's estray record shall cause an advertisement to be set up on the court house door, and in 3 other of the most public places in the county, and also a notice thereof to be published for 3 weeks successively in some public newspaper printed in this state and if the owner of such goods, money, bank notes, or other choses in action does not appear and claim the same and pay the finder's charges and expenses within one year after the advertisement thereof as aforesaid, the ownership of such property shall vest in the finder."

* * *

We think it apparent that the statute to which defendants make reference provides a means of vesting title to lost property in the finder where the prescribed search for the owner proves fruitless. This statute does not purport to provide for the disposition of property deemed mislaid or abandoned nor does it purport to describe or determine the right to possession against any party other than the true owner. The plain meaning of this statute does not support plaintiff's position that common law is wholly abrogated thereby. The provisions of the statute are designed to provide a procedure whereby the discoverer of "lost" property may be vested with the ownership of said property even as against the true owner thereof, a right which theretofore did not exist at common law. In the absence of any language in the statute from which the contrary can be inferred it must be assumed that the term "lost" was used in its generally accepted legal sense and no extension of the term was intended. Thus the right to possession of discovered property still depends upon the relative rights of the discoverer and the owner of the locus in quo and the distinctions which exist between property which is abandoned, mislaid, lost or is treasure trove. The statute assumes that the discoverer is in the rightful possession of lost property and proceedings under such statute is (sic) not a bar where the issue is a claim to the contrary. There is a presumption that the owner or occupant of land or premises has custody of property found on it or actually imbedded in the land. The ownership or possession of the locus in quo is related to the right to possession of property discovered thereon or imbedded therein in two respects. First, if the premises on which the property is discovered are private it is deemed that the property discovered thereon is and always has been in the constructive possession of the owner of said premises and in a legal sense the property can be neither mislaid nor lost. Pyle v. Springfield Marine Bank, 330 Ill App 1, 70 NE2d

257. Second, the question of whether the property is mislaid or lost in a legal sense depends upon the intent of the true owner. The ownership or possession of the premises is an important factor in determining such intent. If the property be determined to be mislaid, the owner of the premises is entitled to the possession thereof against the discoverer. It would also appear that if the discoverer is a trespasser such trespasser can have no claim to possession of such property even if it might otherwise be considered lost.

...The facts as alleged in substance are that the Plaintiff was the owner and in possession of real estate, that the money was discovered in a private area of said premises in a bottle partially imbedded in the soil and that such property was removed from the premises by the finders without any right or authority and in effect as trespassers. We believe the averment of facts in the complaint substantially informs the defendants of the nature of and basis for the claim and is sufficient to state a cause of action. [The trial court's dismissal of the Plaintiff's complaint is reversed and the case is remanded.]

CASE QUESTIONS

1. What is the actual result in this case? Do the young boys get any of the money that they found? Why or why not?
2. Who is Dwayne Bishop, and why is he a plaintiff here? Was it Bishop that put the $12,590 in US currency in a bottle in the landfill at the salvage yard? If not, then who did?
3. If Bishop is not the original owner of the currency, what are the rights of the original owner in this case? Did the original owner "lose" the currency? Did the original owner "misplace" the currency? What difference does it make whether the original owner "lost" or "misplaced" the currency? Can the original owner, after viewing the legal advertisement, have a claim superior to Dwayne Bishop's claim?

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16.9.6: Summary and Exercises

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?

SELF-TEST QUESTIONS

Personal property is defined as property that is

a. not a chattel
b. owned by an individual
c. movable
d. immovable

Personal property can be acquired by

a. accession
b. finding
c. gift
d. all of the above

A gift *causa mortis* is

a. an irrevocable gift
b. a gift made after death
c. a gift made in contemplation of death
d. none of the above

To make a gift effective,

a. the donor must intend to make a gift
b. the donor must either make out a deed or deliver the gift to the donee
c. the donee must accept the gift
d. all of the above are required

Tenant's fixtures

a. remain with the landlord in all cases
b. remain the property of the tenant in all cases
c. remain the property of the tenant if they are removable without substantial damage to the landlord's property
d. refer to any fixture installed by a tenant

SELF-TEST AnswerS

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

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17: INTERNATIONAL LAW

17.1: Introduction
17.2: Introduction to International Law
17.3: Sources and Practice of International Law
17.4: End Notes
17.5: Assessment Questions

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17.1: Introduction

Learning Objectives

- Explain international law and its role in business.



Figure 17.1.1: Introduction (Credit: geralt/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

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17.2: Introduction to International Law

In 1945, President Harry Truman stated, “When Kansas and Colorado have a quarrel over the water in the Arkansas River they don’t call out the National Guard in each state and go to war over it. They bring a suit in the Supreme Court of the United States and abide by the decision. There isn’t a reason in the world why we cannot do that internationally” (Cheeseman, 2016, p. 903). Customs, which vary among global communities and international organizations, are a primary reason why the world cannot pursue such an answer to trade and commerce dealings. The priorities and aims for Chinese businesses differ from those of Brazil. Each of those two countries have radically different business perspectives from the United States. For this reason, international law utilizes customs, treaties, and organizations to guide relationships among nations, with the goal of allowing each country as much leverage as possible over its own business dealings.



Figure 17.2.1: International laws are based on customs, treaties, and organizations that guide partnerships among nations. (Credit: GDJ/ pixabay/ License: CC0)

International Law

International law relates to the policies and procedures that govern relationships among nations (Clarkson, Miller, & Cross, 2018). These are crucial for businesses for multiple reasons. First, there is not a single authoritative legislative source for global business affairs, nor a single world court responsible for interpreting international law (Cheeseman, 2016, p. 903). There is also not a global executive branch that enforces international law, which leaves global business affairs particularly vulnerable.

Secondly, if a nation violates an international law and persuasive tactics fail, then the countries that were violated, or international organizations tasked with overseeing global trade, may act. Often these actions use force to correct the offenses and may include economic sanctions, severance of diplomatic relations, boycotts, or even war against the offending nation (Clarkson, Miller, & Cross, 2018, p. 439).

The purpose of international laws is to permit countries as much authority as possible over their own international business affairs, while maximizing economic benefits of trade and working relationships with other nations. Since many countries have historically allowed governance by international agreements when conducting global business, there exists an evolving body of international laws that facilitate global trade and commerce.

U.S. Constitutional Clauses

There are two important clauses in the U.S. Constitution related to international law. First, the **Foreign Commerce Clause** enables Congress to “regulate commerce with foreign nations” (Cheeseman, 2016, p. 904). This clause permits U.S. businesses to actively negotiate and implement taxes or other regulations as they relate to international commerce. However, businesses

cannot unduly burden foreign commerce. For example, General Motors, which is based in Michigan, cannot suggest that the state impose a 50 percent tax on foreign-made automobiles sold in the state, while not imposing the same tax on U.S.-made vehicles. Michigan can, however, impose a 10 percent tax on all automobile sales in the state to offset the costs of foreign trade and commerce.

The second important clause related to international law is the **Treaty Clause**, which states that the president has the power "by and with the advice and consent of the senate" to create treaties with other nations (Clarkson, Miller, & Cross, 2018, p. 440). This clause restricts treaties to federal authority, meaning that states do not have the power to enter a treaty with another nation. For example, the United States and Mexico can sign a treaty to reduce trade barriers between both nations, but the state of Texas cannot sign a treaty with Mexico to reduce trade barriers between Texas businesses and Mexico. Additionally, any treaties established with other countries become U.S. law, and any conflicting law is null and void.

Primary Sources of International Law

International customs, treaties, and organizations are the primary sources of international law (Clarkson, Miller, & Cross, 2018, p. 439).



Figure $17.2.2$: Three distinct components are sources for how international law is understood, defined, and interpreted around the world. (Modification of art by BNED Credit: CC BY NC SA)

These three components work together to guide how nations understand, define, and interpret international laws that govern global business affairs.

International Customs

Customs are general practices between nations that guide their business relationships. According to the Statute of the International Court of Justice, international customs are "accepted as law" (Clarkson, Miller, & Cross, 2018, p. 439). While customary international law (CIL) is not written, nor does it require ratification to become binding, CIL nonetheless provides guidelines for how nations conduct business affairs (Bradley & Gulati, 2010, p. 204). One example of a custom is the international protection of ambassadors. For thousands of years, ambassadors have been protected while serving diplomatic missions. For this reason, countries protect foreign ambassadors with the understanding that any harm caused to ambassadors would be a violation of international law.

International Treaties

Treaties and other agreements between nations are authorized and ratified by the countries that acknowledge their legality. There are two different types of agreements: bilateral, which is formed by two nations; and multilateral, which is formed by several nations. The Peru-United States Trade Promotion Agreement is an example of a bilateral agreement. It was signed in 2006,

ratified by Peru the same year, and ratified by the United States in 2007. This bilateral agreement is considered beneficial to the United States because it improves access to Peruvian goods, while promoting security and democracy in the South American country. The North American Free Trade Agreement, or NAFTA, is an example of a multilateral agreement. It was ratified in 1994, when Mexico joined the previous trade agreement between the United States and Canada. In September 2018, the Trump administration successfully completed re-negotiations with Mexico and Canada that lasted over one year. Among other aims, these negotiations worked to increase auto industry wages for workers in Mexico and modify pharmaceutical regulations with Canada.

International Organizations

International organizations are comprised of officials who represent member nations that have established a treaty to oversee shared interests, including trade and commerce. The U.S. participates in more than 120 bilateral and multilateral organizations around the world. International organizations adopt resolutions that standardize behavior and create uniform rules related to trade and commerce. Two of the most significant international organizations established in the twentieth century that significantly impact U.S. trade and commerce are the United Nations and the European Union.

United Nations

The United Nations (UN) was created as a multilateral treaty in 1945. The UN's organizational goals include maintaining global peace and security, promoting economic and social cooperation, and protecting human rights, especially related to women and children (Cheeseman, 2016, p. 905). The UN **General Assembly** includes representatives from each member nation. As of 2018, the UN acknowledges 195 sovereign states, with all but two participating as full members. These two, Palestine and the Vatican City, are classified as "observer states." Six additional countries are not UN members, but are recognized as a country by at least one UN member country: Abkhazia, Kosovo, Northern Cypress, South Ossetia, Taiwan, and Western Sahara.

The **UN Security Council** includes five permanent members and 10 countries selected by the General Assembly to serve two-year terms. The five countries that hold permanent membership are China, France, Russia, the United Kingdom, and the United States (Cheeseman, 2016, p. 558). This Council is primarily responsible for overseeing global peace and security measures. The World Bank is a UN organization, financed by contributions from developed countries and headquartered in Washington, D.C. Its primary functions include providing money to developing countries to fund projects that relieve suffering, including building roads and dams, establishing hospitals, developing agriculture, and other humanitarian efforts. The World Bank provides both grants and long-term low interest rate loans to countries, often granting debt relief for outstanding loans (Cheeseman, 2016, p. 559).

The United Nations Commission International Trade Law is one of the most important international organizations to date, establishing the 1980 Convention on Contracts for the International Sale of Goods (CISG), which will be discussed further in the next section.

European Union

The **European Union (EU)** is a regional international organization that includes many countries in Europe. It was established to create peace across the region and promote economic, social, and cultural development (Cheeseman, 2016, p. 561). As of 2018, there are 28 countries affiliated with the EU, although the United Kingdom has begun steps to withdraw its membership. Additionally, Macedonia is actively seeking a path toward EU membership, although as of September 2018, the country's citizens remain divided. The EU organization has established a treaty for its members that creates open borders for trade among member nations, especially for capital, labor, goods, and services. The impact on U.S. commerce is significant, as the EU represents more than 500 million people and a gross community product that exceeds that of the United States, Canada, and Mexico combined (Cheeseman, 2016, p. 561).

Sovereignty

National **sovereignty** defines a nation. While clearly defined borders and independent governments also set parameters for a nation, sovereignty is an important legal principle that allows nations to enter negotiated treaties with other countries and honor territorial boundaries. It is among the most important international law principles, thus greatly impacting international trade and commerce.

Since the 1800s, most established nations allowed for absolute sovereignty among the global community. However, by the 1940s, that allowance was significantly reduced, as countries revisited sovereignty in light of globalization, transportation, and communication advances, and the rise of international organizations (Goldsmith, 2000, p. 959). Consequentially, doctrines of limited immunity were created that established guidelines for how countries may prosecute, or hold foreign nationals accountable, during international trade and commerce dealings.

A **doctrine of sovereign immunity** states that countries are granted immunity from lawsuits in courts of other countries (p. 569). Although the United States initially granted absolute immunity to foreign governments from lawsuits in U.S. courts, in 1952, the United States adapted federal law to qualified immunity, which is the immunity regulation adopted in most Western nations. This law led to the **Foreign Sovereign Immunities Act of 1976**, allowing U.S. governance over lawsuits against other nations in the United States in either federal- or state-level courts. Simply stated, a foreign country is not immune to lawsuits in the United States when the country has waived its immunity, or if the commercial activity against which the lawsuit is intended causes a direct effect in the United States.

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17.3: Sources and Practice of International Law

International law is primarily governed by customs, treaties, and organizations that influence how laws are understood, interpreted, and enforced around the world. Since there is not a central court to enforce international law, each country utilizes its own courts to settle disputes. Collective action, reciprocity, and shaming are three examples of non-legislative methods that influence trade when enacted against nations that violate international law.



Figure 17.3.1: International laws are enforced through positive and punitive measures that seek to uphold the global integrity of trade and commerce among all nations. (Credit: qimono/ pixabay/ CC0)

Sources of International Law

The sources of international law are customs, treaties, and organizations, as discussed in the previous section. These three components work synergistically to influence how the international community facilitates business trade and commerce. More importantly, international law is enforced when a country violates the principles set forth by globally shared customs, treaties, and organizations.

One of the most important governing documents for international law is the **United Nations Convention on Contracts for the International Sale of Goods (CISG)**, which was established in 1980. This law governs contracts of countries that have ratified it as the priority contract for trade. By January 2018, 84 countries had adopted CISG, including the countries that account for more than two-thirds of all global trade. Those countries include the United States, Canada, China, Japan, Mexico, Argentina, Brazil, and most European countries. The CISG is enforced whenever international transactions occur without the presence of written contracts to govern those transactions. There are limits to the CISG, however, as the CISG does not apply to consumer sales or contracts for services (Clarkson, Miller, & Cross, 2018, p. 376).

International Principles and Doctrines

There are three significant principles that help establish and enforce international law: the Principle of Comity, the Act of State Doctrine, and the Doctrine of Sovereign Immunity.

The **Principle of Comity** states that nations will defer to the laws and decrees of other nations when those laws are consistent with their own, essentially upholding reciprocity between nations with similar laws. For example, a U.S. court will most likely uphold a business contract as valid even if it was drafted in England, since the United Kingdom's legal procedures are consistent with U.S. procedures (Cross & Miller, 2018, p. 216).

The **Act of State Doctrine** is a law applicable in England and the United States. It states that these two nations will not pass legal judgement on public acts committed by a recognized government if those acts occur within that government's own territory (Cross & Miller, 2018, p. 216). For example, the United States will not file a lawsuit against Petrobras, a Brazilian oil company, alleging price fixing, since the act of pricing oil occurs in Brazil, which is a nation that holds control over its own natural resources.

The **Doctrine of Sovereign Immunity**, which was introduced in the previous section, states that foreign nations are immune from U.S. jurisdiction when certain circumstances are applied. However, there are exceptions to this law. If a foreign country conducts commercial business activity in the United States and an entity in the United States files a lawsuit against the foreign business, then the foreign state is not immune from U.S. jurisdiction (Cross & Miller, 2018, p. 216).

International Law Enforcement

One of the most important considerations for international business is understanding that companies operating in foreign nations are subject to the laws of those nations (Cross & Miller, 2018, p. 212). When international laws are violated, disputes are often resolved through the legal systems within individual nations. Most countries have either common law or civil law systems. **Common law systems** operate independently by developing their own rules that govern areas of business law, such as torts and contracts. The United States has a common law system. One-third of all people in the world live in nations in which common law is practiced. **Civil law systems** base their legislation on Roman civil law, which utilizes statutory codes as the primary source of law (p. 212).

Table 17.3.1: Common Law Civil Law

Australia	Malaysia	Argentina	Indonesia
Bangladesh	New Zealand	Austria	Iran
Canada	Nigeria	Brazil	Italy
Ghana	Singapore	Chile	Japan
India	United Kingdom	China	Mexico
Israel	United States	Egypt	Poland
Jamaica	Zambia	Finland	South Korea
Kenya		France	Sweden
		Germany	Tunisia
		Greece	Venezuela

Impact on International Trade

There are three international law enforcement methods that can radically impact trade: collective action, reciprocity, and shaming.

Collective action occurs when businesses work collectively to strengthen their resources and achieve a shared goal. In February 2018, the UN Conference on Trade and Development Secretary-General argued that collective action can be one of the most effective methods for protecting international trade in the current global climate. Due to recent trade restructuring from the United States and the United Kingdom (pending its withdrawal from the EU), collective action was promoted as a way to "harness energy that will not fragment the [international trade] system" (UNCTAD, 2018). By leveraging nations to defend "rules-based multilateral trading systems as a force for creating inclusive prosperity," the Secretary-General promoted collective action as the primary way to assure continued international peace and economic viability for generations to come.

Reciprocity is central to international trade and at the core of CIL. It happens most commonly in international business exchanges as countries lower import duties, or other trade barriers, in exchange for mutual arrangements extended by the other country. Reciprocity can be beneficial to the nations involved, or it can be punitive. In 2016, presidential candidate Donald Trump campaigned for an international trade climate that would produce fairer options for the United States. Since his inauguration, he has increasingly pressured the global community by imposing taxes on imports from Canada, China, the EU, and Mexico, each of which has retaliated in reciprocity. In 2018, China accused the United States of launching the "largest trade war in economic history," of which the final global impacts remain largely unknown (BBC, 2018).

Shaming is a deliberate attempt to negatively impact a state, regime, or governmental leader's reputation by publicizing and targeting violations of international laws, including customary norms, treaty breaches, and violations of organizational expectations (Gopalan & Fuller, 2014, p. 75). However, shaming is not viewed as particularly effective without more concrete measures to accompany it (Klymak, 2017). A recent research study conducted by the Department of Economics in Dublin, Ireland, found that there is no evidence to suggest that there has been a decrease in the imports of goods to the United States from countries where foreign goods are likely produced by child and forced labor. Despite media coverage and the International Labour Organization's coverage that routinely shames certain nations for producing goods by child or forced labor, those goods are nonetheless regularly imported for international sale.

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17.4: End Notes

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17.5: Assessment Questions

1. What is International law?

   Answer

   International law relates to the policies and procedures that govern relationships among nations.

2. The following are clauses in the U.S. Constitution that relate to international law.
   a. Treaty Clause.
   b. Foreign Commerce Clause.
   c. Both a and b.
   d. Neither a nor b.
3. Explain the European Union.

   Answer

   The European Union (EU) is a regional international organization that includes many countries in Europe. It was established to create peace across the region and promote economic, social, and cultural development.

4. What is the Doctrine of Sovereign Immunity?
5. The UN Security Council is made up of:
   a. 5 members and 10 countries.
   b. 10 members and 5 countries.
   c. 10 members and 10 countries.
   d. 5 members and 5 countries.

   Answer

   a

6. Sources of international law include:
   a. Customs, treaties, and laws.
   b. Customs, treaties, and edict.
   c. Treaties, laws, and edicts.
   d. Customs, treaties, and organizations.
7. Explain the principle of comity.

   Answer

   The Principle of Comity states that nations will defer to the laws and decrees of other nations when those laws are consistent with their own, essentially upholding reciprocity between nations with similar laws.

8. Compare and contrast common law systems vs. civil law systems.
9. How many countries have adopted the United Nations Convention on Contracts for the International Sale of Goods (CISG)?
   a. 74
   b. 84
   c. 94
   d. 104

   Answer

   b

10. All of the following are international law enforcement methods except:
    a. Collective action.
    b. Reciprocity.

c. Shaming.
d. All of the above.

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18: INTRODUCTION TO PROPERTY- PERSONAL PROPERTY AND FIXTURES

18.1: Chapter Introduction

18.2: The General Nature of Property Rights

18.3: Personal Property

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18.6: Summary and Exercises

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18.1: Chapter Introduction

Learning Objectives

After reading this chapter, you should understand the following:

1. The difference between personal property and other types of property
2. How rights in personal property are acquired and maintained
3. How some kinds 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. In Chapter 18 "Intellectual Property", we discuss intellectual property, a kind of personal property that is increasingly profitable.

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18.2: The General Nature of Property Rights

Learning Objectives

1. Understand the elastic and evolving boundaries of what the law recognizes as property that can be bought or sold on the market.
2. 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 even fifteen 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 36.3 "Fixtures" 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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18.3: Personal Property

Learning Objectives

1. 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 36.2.2 "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 36.4.1 "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 36.4.1 "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

Figure 36.1 Gift 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* (see Figure 36.1 "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.

Gift Tax

The federal government and many states impose gift taxes on gifts above a certain dollar amount.

Accession

An **accession** is something that is added to what one already possesses. In general, the rule is that the owner of the thing owns the additional thing that comes to be attached to it. For example, the owner of a cow owns her calves when she gives birth. But

when one person adds value to another person's property, either through labor alone or by adding new materials, the rule must be stated somewhat differently. The general rule is this: when goods are added to goods, the owner of the principal goods becomes the owner of the enhanced product. For example, a garage uses its paint to repaint its customer's automobile. The car owner, not the painter, is the owner of the finished product.

When someone has wrongfully converted—that is, taken as her own—the property of another, the owner may sue for damages, either to recover his property or its value. But a problem arises when the converter has added to the value of that property. In general, the courts hold that when the conversion is willful, the owner is entitled to the full value of the goods as enhanced by the converter. Suppose that a carpenter enters a ten-acre forest that he knows belongs to his neighbor, cuts down one hundred trees, transports them to his shop, and cuts them up into standard lumber, thus increasing their market value. The owner is entitled to this full value, and the carpenter will get nothing for his trouble. Thus the willful converter loses the value of his labor or materials. If, on the other hand, the conversion was innocent, or at most negligent, the rule is somewhat more uncertain. Generally the courts will award the forest owner the value of the standing timber, giving the carpenter the excess attributable to his labor and transportation. A more favorable treatment of the owner is to give her the full value of the lumber as cut, remitting to the carpenter the value of his expenses.

Confusion

In accession, the goods of one owner are transformed into a more valuable commodity or are inextricably united with the goods of another to form a constituent part. Still another type of joining is known as **confusion**, and it occurs when goods of different owners, while maintaining their original form, are commingled. A common example is the intermingling of grain in a silo. But goods that are identifiable as belonging to a particular person—branded cattle, for instance—are not confused, no matter how difficult it may be to separate herds that have been put together.

When the goods are identical, no particular problem of division arises. Assuming that each owner can show how much he has contributed to the confused mass, he is entitled to that quantity, and it does not matter which particular grains or kernels he extracts. So if a person, seeing a container of grain sitting on the side of the road, mistakes it for his own and empties it into a larger container in his truck, the remedy is simply to restore a like quantity to the original owner. When owners of like substances consent to have those substances combined (such as in a grain silo), they are said to be tenants in common, holding a proportional share in the whole.

In the case of willful confusion of goods, many courts hold that the wrongdoer forfeits all his property unless he can identify his particular property. Other courts have modified this harsh rule by shifting the burden of proof to the wrongdoer, leaving it up to him to claim whatever he can establish was his. If he cannot establish what was his, then he will forfeit all. Likewise, when the defendant has confused the goods negligently, without intending to do so, most courts will tend to shift to the defendant the burden of proving how much of the mass belongs to him.

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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18.4: Fixtures

Learning Objectives

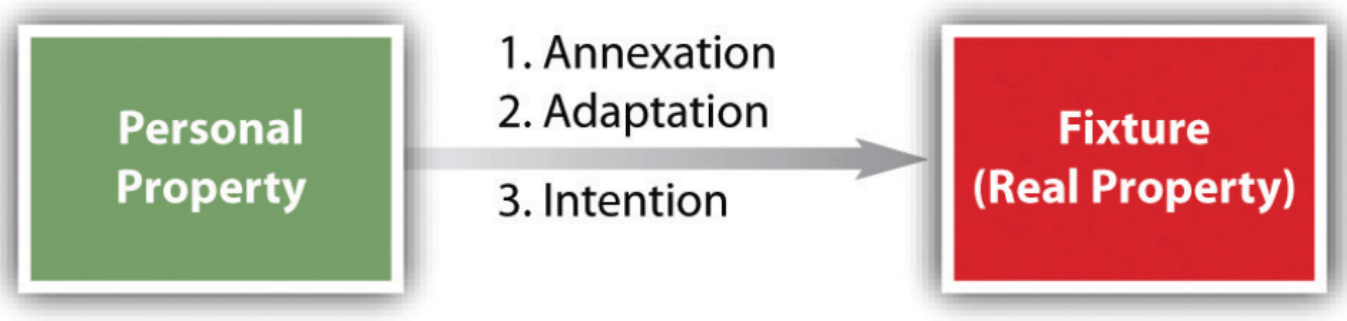
1. Know the three tests for when personal property becomes a fixture and thus becomes real property.

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

Figure 36.2 Fixture 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 (see Figure 36.2 "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 (Chapter 33 "Secured Transactions and Suretyship"). 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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18.5: Case

Lost or Misplaced Property

Bishop v. Ellsworth

91 Ill. App.2d 386, 234 N.E. 2d 50 (1968)

OPINION BY: STOUDER, Presiding Justice

Dwayne Bishop, plaintiff, filed a complaint alleging that on July 21, 1965, defendants, Mark and Jeff Ellsworth and David Gibson, three small boys, entered his salvage yard premises at 427 Mulberry Street in Canton, without his permission, and while there happened upon a bottle partially embedded in the loose earth on top of a landfill, wherein they discovered the sum of $12,590 in US currency. It is further alleged that said boys delivered the money to the municipal chief of police who deposited it with defendant, Canton State Bank. The complaint also alleges defendants caused preliminary notices to be given as required by Ill. Rev. Stats., chapter 50, subsections 27 and 28 (1965), but that such statute or compliance therewith does not affect the rights of the plaintiff. [The trial court dismissed the plaintiff's complaint.]

...It is defendant's contention that the provisions of Ill Rev Stats, chapter 50, subsections 27 and 28 govern this case. The relevant portions of this statute are as follows:

"27. Lost goods...If any person or persons shall hereafter find any lost goods, money, bank notes, or other choses in action, of any description whatever, such person or persons shall inform the owner thereof, if known, and shall make restitution of the same, without any compensation whatever, except the same shall be voluntarily given on the part of the owner. If the owner be unknown, and if such property found is of the value of $ 15 or upwards, the finder...shall, within five days after such finding...appear before some judge or magistrate...and make affidavit of the description thereof, the time and place when and where the same was found, that no alteration has been made in the appearance thereof since the finding of the same, that the owner thereof is unknown to him and that he has not secreted, withheld or disposed of any part thereof. The judge or magistrate shall enter the value of the property found as near as he can ascertain in his estray book together with the affidavit of the finder, and shall also, within ten days after the proceedings have been entered on his estray book, transmit to the county clerk a certified copy thereof, to be by him recorded in his estray book and to file the same in his office...28. Advertisement...If the value thereof exceeds the sum of $ 15, the county clerk, within 20 days after receiving the certified copy of the judge or magistrate's estray record shall cause an advertisement to be set up on the court house door, and in 3 other of the most public places in the county, and also a notice thereof to be published for 3 weeks successively in some public newspaper printed in this state and if the owner of such goods, money, bank notes, or other choses in action does not appear and claim the same and pay the finder's charges and expenses within one year after the advertisement thereof as aforesaid, the ownership of such property shall vest in the finder."

* * *

We think it apparent that the statute to which defendants make reference provides a means of vesting title to lost property in the finder where the prescribed search for the owner proves fruitless. This statute does not purport to provide for the disposition of property deemed mislaid or abandoned nor does it purport to describe or determine the right to possession against any party other than the true owner. The plain meaning of this statute does not support plaintiff's position that common law is wholly abrogated thereby. The provisions of the statute are designed to provide a procedure whereby the discoverer of "lost" property may be vested with the ownership of said property even as against the true owner thereof, a right which theretofore did not exist at common law. In the absence of any language in the statute from which the contrary can be inferred it must be assumed that the term "lost" was used in its generally accepted legal sense and no extension of the term was intended. Thus the right to possession of discovered property still depends upon the relative rights of the discoverer and the owner of the locus in quo and the distinctions which exist between property which is abandoned, mislaid, lost or is treasure trove. The statute assumes that the discoverer is in the rightful possession of lost property and proceedings under such statute is (sic) not a bar where the issue is a claim to the contrary. There is a presumption that the owner or occupant of land or premises has custody of property found on it or actually imbedded in the land. The ownership or possession of the locus in quo is related to the right to possession of property discovered thereon or imbedded therein in two respects. First, if the premises on which the property is discovered are private it is deemed that the property discovered thereon is and always has been in the constructive possession of the owner of said premises and in a legal sense the property can be neither mislaid nor lost. Pyle v. Springfield Marine Bank, 330 Ill App 1, 70 NE2d

257. Second, the question of whether the property is mislaid or lost in a legal sense depends upon the intent of the true owner. The ownership or possession of the premises is an important factor in determining such intent. If the property be determined to be mislaid, the owner of the premises is entitled to the possession thereof against the discoverer. It would also appear that if the discoverer is a trespasser such trespasser can have no claim to possession of such property even if it might otherwise be considered lost.

...The facts as alleged in substance are that the Plaintiff was the owner and in possession of real estate, that the money was discovered in a private area of said premises in a bottle partially imbedded in the soil and that such property was removed from the premises by the finders without any right or authority and in effect as trespassers. We believe the averment of facts in the complaint substantially informs the defendants of the nature of and basis for the claim and is sufficient to state a cause of action. [The trial court's dismissal of the Plaintiff's complaint is reversed and the case is remanded.]

CASE QUESTIONS

1. What is the actual result in this case? Do the young boys get any of the money that they found? Why or why not?
2. Who is Dwayne Bishop, and why is he a plaintiff here? Was it Bishop that put the $12,590 in US currency in a bottle in the landfill at the salvage yard? If not, then who did?
3. If Bishop is not the original owner of the currency, what are the rights of the original owner in this case? Did the original owner "lose" the currency? Did the original owner "misplace" the currency? What difference does it make whether the original owner "lost" or "misplaced" the currency? Can the original owner, after viewing the legal advertisement, have a claim superior to Dwayne Bishop's claim?

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18.6: Summary and Exercises

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?

SELF-TEST QUESTIONS

Personal property is defined as property that is

a. not a chattel
b. owned by an individual
c. movable
d. immovable

Personal property can be acquired by

a. accession
b. finding
c. gift
d. all of the above

A gift *causa mortis* is

a. an irrevocable gift
b. a gift made after death
c. a gift made in contemplation of death
d. none of the above

To make a gift effective,

a. the donor must intend to make a gift
b. the donor must either make out a deed or deliver the gift to the donee
c. the donee must accept the gift
d. all of the above are required

Tenant's fixtures

a. remain with the landlord in all cases
b. remain the property of the tenant in all cases
c. remain the property of the tenant if they are removable without substantial damage to the landlord's property
d. refer to any fixture installed by a tenant

SELF-TEST AnswerS

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

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19: ESTATE PLANNING - WILLS, ESTATES, AND TRUSTS

19.1: Wills and Estate Administration
19.2: Trusts
19.3: Factors Affecting Estates and Trusts
19.4: Cases
19.5: Summary and Exercises

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19.1: Wills and Estate Administration

Learning Objectives

1. Describe how property, both real and personal, can be devised and bequeathed to named heirs in a will.
2. Understand what happens to property of a decedent when there is no will.
3. Explain the requirements for "testamentary capacity"—what it takes to make a valid will that can be admitted to probate.
4. Describe the steps in the probate and administration of a will.

Definition

A will is the declaration of a person's wishes about the disposition of his assets on his death. Normally a written document, the will names the persons who are to receive specific items of real and personal property. Unlike a contract or a deed, a will is not binding as long as the person making the will lives. He may revoke it at any time. Wills have served their present function for virtually all of recorded history. The earliest known will is from 1800 BC (see Figure 19.1.1 "An Ancient Will"). Even if somewhat different in form, it served the same basic function as a modern will.

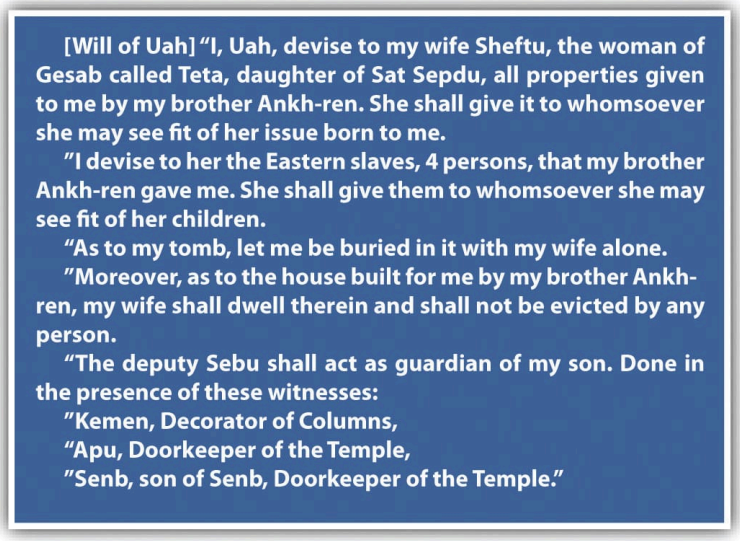

[Will of Uah] "I, Uah, devise to my wife Sheftu, the woman of Gesab called Teta, daughter of Sat Sepdu, all properties given to me by my brother Ankh-ren. She shall give it to whomsoever she may see fit of her issue born to me.
"I devise to her the Eastern slaves, 4 persons, that my brother Ankh-ren gave me. She shall give them to whomsoever she may see fit of her children.
"As to my tomb, let me be buried in it with my wife alone.
"Moreover, as to the house built for me by my brother Ankh-ren, my wife shall dwell therein and shall not be evicted by any person.
"The deputy Sebu shall act as guardian of my son. Done in the presence of these witnesses:
"Kemen, Decorator of Columns,
"Apu, Doorkeeper of the Temple,
"Senb, son of Senb, Doorkeeper of the Temple."

Figure 19.1.1: An Ancient Will. Source: *John H. Wigmore, A Panorama of the World's Legal Systems, vol.* 1, p. 22.

Although most wills are written in a standardized form, some special types of wills are enforceable in many states.

1. A *nuncupative will* is one that is declared orally in front of witnesses. In states where allowed, the statutes permit it to be used only when the testator is dying as he declares his will. (A testator is one who dies with a will.)
2. A *holographic will* is one written entirely by the testator's hand and not witnessed. At common law, a holographic will was invalid if any part of the paper on which it was written contained printing. Modern statutes tend to validate holographic wills, even with printing, as long as the testator who signs it puts down material provisions in his own hand.
3. *Soldiers' and sailors' wills* are usually enforceable, no matter how informal the document, if made while the soldier is on service or the sailor is at sea (although they cannot usually transfer real property without observing certain formalities).
4. A *conditional will* is one that will take effect only on the happening of a particular named event. For example, a man intending to marry might write, "This will is contingent on my marrying Alexa Jansey." If he and Ms. Jansey do not marry, the will can have no operational effect.
5. A *joint will* is one in which two (or more) people use the same instrument to dispose of their assets. It must be signed by each person whose assets it is to govern.
6. *Mutual* or *reciprocal wills* are two or more instruments with reciprocal terms, each written by a person who intends to dispose

of his or her assets in favor of the others.

The Uniform Probate Code

Probate is the process by which a deceased's estate is managed under the supervision of a court. In most states, the court supervising this process is a specialized one and is often called the probate court. Probate practices vary widely from state to state, although they follow a general pattern in which the assets of an estate are located, added up, and disbursed according to the terms of the will or, if there is no will, according to the law of intestate succession. To attempt to bring uniformity into the conflicting sets of state laws the National Conference of Commissioners on Uniform State Laws issued the Uniform Probate Code (UPC) in 1969, and by 2011 it had been adopted in its entirety in sixteen states. Several other states have adopted significant parts of the UPC, which was revised in 2006. Our discussion of wills and estate administration is drawn primarily from the UPC, but you should note that there are variations among the states in some of the procedures standardized in the UPC.

Will Requirements and Interpretation

Capacity

Any person who is over eighteen and of "sound mind" may make a will. One who is insane may not make an enforceable will, although the degree of mental capacity necessary to sustain a will is generally said to be a "modest level of competence" and is lower than the degree of capacity people must possess to manage their own affairs during their life. In other words, a court might order a guardian to manage the affairs of one who is mentally deficient but will uphold a will that the person has written. Insanity is not the only type of mental deficiency that will disqualify a will; medication of a person for serious physical pain might lead to the conclusion that the person's mind was dulled and he did not understand what he was doing when writing his will. The case *Estate of Seymour M. Rosen*, (see Section 14.4.1 "Testamentary Capacity"), considers just such a situation.

Writing

Under the UPC, wills must be in writing. The will is not confined to the specific piece of paper called "will" and signed by the testator. It may incorporate by reference any other writing in existence when the will is made, as long as the will sufficiently identifies the other writing and manifests an intent to incorporate it. Although lawyers prepare neatly typed wills, the document can be written in pencil or pen and on any kind of paper or even on the back of an envelope. Typically, the written will has the following provisions: (1) a "publication clause," listing the testator's name and his or her intention to make a will; (2) a "revocation clause," revoking all previously made wills; (3) burial instructions; (4) debt payments, listing specific assets to be used; (5) bequests, which are gifts of personal property by will; (6) devises, which are gifts of real property by will; (7) a "residuary clause," disposing of all property not covered by a specific bequest or devise; (8) a "penalty clause," stating a penalty for anyone named in the will who contests the will; (9) the name of minor children's guardian; and (10) the name of the executor. The executor's job is to bring in all the assets of an estate, pay all just claims, and make distribution to beneficiaries in accord with the testator's wishes. Beginning with California in 1983, several states have adopted statutory wills—simple fill-in-the-blank will forms that can be completed without consulting an attorney.

Signature

The testator must sign the will, and the proper place for the signature is at the end of the entire document. The testator need not sign his full name, although that is preferable; his initials or some other mark in his own hand, intended as an execution of the document, will suffice. The UPC permits someone else to sign for the testator as long as the signing is done in the testator's presence and by his or her direction.

Witnesses

Most states require two or three witnesses to sign the will. The UPC requires two witnesses. The witnesses should observe the testator sign the will and then sign it themselves in the presence of each other. Since the witnesses might be asked to attest in court to the testator's signature, it is sound practice to avoid witnesses who are unduly elderly and to use an extra witness or two. Most states forbid a person who has an interest in the will—that is, one who is a beneficiary under the will—from witnessing.

In some states, a beneficiary who serves as a witness will lose his or her right to a bequest or devise. The UPC differs from the usual rule: no will or any provision of a will is invalid because an interested party witnesses it, nor does the interested witness forfeit a bequest or devise.

Revocation and Modification

Since wills are generally effective only at death, the testator may always revoke or amend a will during his lifetime. He may do so by tearing, burning, obliterating, or otherwise destroying it. A subsequent will has the effect of revoking an inconsistent prior will, and most wills expressly state that they are intended to revoke all prior wills. A written modification of or supplement to a prior will is called a codicil. The codicil is often necessary, because circumstances are constantly changing. The testator may have moved to a new state where he must meet different formal requirements for executing the will; one of his beneficiaries may have died; his property may have changed. Or the law, especially the tax law, may have changed.

One exception to the rule that wills are effective only at death is the so-called living will. Beginning with California in 1976, most states have adopted legislation permitting people to declare that they refuse further treatment should they become terminally ill and unable to tell physicians not to prolong their lives if they can survive only by being hooked up to life-preserving machines. This living will takes effect during the patient's life and must be honored by physicians unless the patient has revoked it. The patient may revoke at any time, even as he sees the doctor moving to disconnect the plug.

In most states, a later marriage revokes a prior will, but divorce does not. Under the UPC, however, a divorce or annulment revokes any disposition of property bequeathed or devised to the former spouse under a will executed prior to the divorce or annulment. A will is at least partially revoked if children are born after it is executed, unless it has either provided for subsequently born children or stated the testator's intention to disinherit such children.

Abatement

Specific bequests listed in a will might not be available in the estate when the testator or testatrix dies. Abatement of a bequest happens when there are insufficient assets to pay the bequest. Suppose the testatrix leaves $10,000 each to "my four roommates," but when she dies, her estate is worth only $20,000. The gift to each of the roommates is said to have abated, and each will take only $5,000.

Abatement can pose a serious problem in wills not carefully drafted. Since circumstances can always change, a general provision in a father's will, providing "my dear daughter with all the rest, residue, and remainder of my estate," will do her little good if business reverses mean that the $10,000 bequest to the local hospital exhausts the estate of its assets—even though at the time the will was made, the testator had assets of $1 million and supposed his daughter would be getting the bulk of it. Since specific gifts must be paid out ahead of general bequests or devises, abatement can cause the residual legatee (the person taking all assets not specifically distributed to named individuals) to suffer.

Ademption

Suppose that a testator bequeathed her 1923 Rolls Royce to "my faithful secretary," but that the car had been sold and she owned only a 1980 Volkswagen when she died. Since the Rolls was not part of the estate, it is said to have adeemed (to have been taken away). Ademption of a gift in a will means that the intended legatee (the person named in the will) forfeits the object because it no longer exists. An object used as a substitute by the testator will not pass to the legatee unless it is clear that she intended the legatee to have it.

Intestacy

Intestacy means dying without a will. Intestacy happens all too frequently; even those who know the consequences for their heirs often put off making a will until it is too late—Abraham Lincoln, for one, who as an experienced lawyer knew very well the hazards to heirs of dying intestate. On his death, Lincoln's property was divided, with one-third going to his widow, one-third to a grown son, and one-third to a twelve-year-old son. Statistics show that in New York, about one-third of the people who die with estates of $5,000 or more die without wills. In every state, statutes provide for the disposition of property of decedents dying without wills. If you die without a will, the state in effect has made one for you. Although the rules vary by statute from state to state, a common distribution pattern prevails.

Unmarried Decedent

At common law, parents of an intestate decedent could not inherit his property. Today, however, many states provide that parents will share in the property. If the parents have already died, then the estate will pass to collateral heirs (siblings, nieces, nephews, aunts, and uncles). If there are no collateral heirs, most state laws provide that the next surviving kin of equal degree will share the property equally (e.g., first cousins). If there are no surviving kin, the estate escheats (es CHEETS) to the state, which is then the sole owner of the assets of the estate.

Married with No Children

In some states, the surviving spouse without children will inherit the entire estate. In other states, the spouse must share the property with the decedent's parents or, if they are deceased, with the collateral heirs.

Married with Children

In general, the surviving spouse will be entitled to one-third of the estate, and the remainder will pass in equal shares to living children of the decedent. The share of any child who died before the decedent will be divided equally among that child's offspring. These grandchildren of the decedent are said to take per stirpes (per STIR peas), meaning that they stand in the shoes of their parent. Suppose that the decedent left a wife, three children, and eight grandchildren (two children each of the three surviving children and two children of a fourth child who predeceased the decedent), and that the estate was worth $300,000. Under a typical intestate succession law, the widow would receive property worth $100,000. The balance of the property would be divided into four equal parts, one for each of the four children. The three surviving children would each receive $50,000. The two children of the fourth child would each receive $25,000. The other grandchildren would receive nothing.

A system of distribution in which all living descendants share equally, regardless of generation, is said to be a distribution per capita. In the preceding example, after the widow took her share, the remaining sum would be divided into eleven parts, three for the surviving children and eight for the surviving grandchildren.

Unmarried with Children

If the decedent was a widow or widower with children, then the surviving children generally will take the entire estate.

Estate Administration

To carry on the administration of an estate, a particular person must be responsible for locating the estate property and carrying out the decedent's instructions. If named in the will, this person is called an executor. When a woman serves, she is still known in many jurisdictions as an executrix. If the decedent died intestate, the court will appoint an administrator (or administratrix, if a woman), usually a close member of the family. The UPC refers to the person performing the function of executor or administrator as a personal representative. Unless excused by the will from doing so, the personal representative must post a bond, usually in an amount that exceeds the value of the decedent's personal property.

The personal representative must immediately become familiar with the decedent's business, preserve the assets, examine the books and records, check on insurance, and notify the appropriate banks.

When confirmed by the court (if necessary), the personal representative must offer the will in probate—that is, file the will with the court, prove its authenticity through witnesses, and defend it against any challenges. Once the court accepts the will, it will enter a formal decree admitting the will to probate.

Traditionally, a widow could make certain elections against the will; for example, she could choose dower and homestead rights. The right of dower entitled the widow to a life estate in one-third of the husband's inheritable land, while a homestead right is the right to the family home as measured by an amount of land (e.g., 160 acres of rural land or 1 acre of urban land in Kansas) or a specific dollar amount. In some states, this amount is quite low (e.g., $4,000 in Kansas) where the legislature has not upwardly adjusted the dollar amount for many years.

Today, most states have eliminated traditional dower rights. These states give the surviving spouse (widow or widower) the right to reject provisions made in a will and to take a share of the decedent's estate instead.

Once the will is admitted to probate, the personal representative must assemble and inventory all assets. This task requires the personal representative to collect debts and rent due, supervise the decedent's business, inspect the real estate, store personal and household effects, prove the death and collect proceeds of life insurance policies, take securities into custody, and ascertain whether the decedent held property in other states. Next, the assets must be appraised as of the date of death. When inventory and appraisal are completed, the personal representative must decide how and when to dispose of the assets by answering the following sorts of questions: Should a business be liquidated, sold, or allowed to continue to operate? Should securities be sold, and if so, when? Should the real estate be kept intact under the will or sold? To whom must the personal effects be given?

The personal representative must also handle claims against the estate. If the decedent had unpaid debts while alive, the estate will be responsible for paying them. In most states, the personal representative is required to advertise that the estate is in probate. When all claims have been gathered and authenticated, the personal representative must pay just claims in order of priority. In general (though by no means in every state), the order of priority is as follows: (1) funeral expenses, (2) administration expenses (cost of bond, advertising expenses, filing fees, lawsuit costs, etc.), (3) family allowance, (4) claims of the federal government, (5) hospital and other expenses associated with the decedent's last illness, (6) claims of state and local governments, (7) wage claims, (8) lien claims, (9) all other debts. If the estate is too small to cover all these claims, every claim in the first category must be satisfied before the claims in the second category may be paid, and so on.

Before the estate can be distributed, the personal representative must take care of all taxes owed by the estate. She will have to file returns for both estate and income taxes and pay from assets of the estate the taxes due. (She may have to sell some assets to obtain sufficient cash to do so.) Estate taxes—imposed by the federal government and based on the value of the estate—are nearly as old as the Republic; they date back to 1797. They were instituted originally to raise revenue, but in our time they serve also to break up large estates.

As of 2011, the first $1 million of an estate is exempt from taxation, lowering the threshold from an earlier standard. The Tax Policy Institute of the Brookings Institution estimates that 108,200 estates of people dying in 2011 will file estate tax returns, and 44,200 of those estates will pay taxes totaling $34.4 billion.

Although a unified tax is imposed on gifts during life and transfers at death, everyone is permitted to give away $13,000 per donee each year without paying any tax on the gift. A tax on sizable gifts is imposed to prevent people with large estates from giving away during their lives portions of their estate in order to escape estate taxes. Thus two grandparents with two married children and four grandchildren may give away $26,000 ($13,000 from each grandparent) to their eight descendants (children, spouses, grandchildren) each year, for a total of $208,000, without paying any tax.

State governments also impose taxes at death. In many states, these are known as inheritance taxes and are taxes on the heir's right to receive the property. The tax rate depends on the relationship to the decedent: the closer the relation, the smaller the tax. Thus a child will pay less than a nephew or niece, and either of them will pay less than an unrelated friend who is named in the will.

Once the taxes are paid, a final accounting must be prepared, showing the remaining principal, income, and disbursements. Only at this point may the personal representative actually distribute the assets of the estate according to the will.

key takeaway

Any person with the requisite capacity may make a will and bequeath personal property to named heirs. A will can also devise real property. Throughout the United States, there are fairly common requirements to be met for a will to qualify for probate.

Intestacy statutes will govern where there is no will, and an administrator will be appointed by the probate court. Intestacy statutes will dictate which relatives will get what portion of the decedent's estate, portions that are likely to differ from what the decedent would have done had he or she left a valid will. Where there are no heirs, the decedent's property escheats to the state.

An executor (or executrix) is the person named in the will to administer the estate and render a final accounting. Estate and inheritance taxes may be owed if the estate is large enough.

Exercises 19.1.1

1. Donald Trump is married to Ivanna Trump, but they divorce. Donald neglects to change his will, which leaves everything to Ivanna. If he were to die before remarrying, would the will still be valid?
2. Tom Tyler, married to Tina Tyler, dies without a will. If his legal state of residence is California, how will his estate be distributed? (This will require a small amount of Internet browsing.)
3. Suppose Tom Tyler is very wealthy. When he dies at age sixty-three, there are two wills: one leaves everything to his wife and family, and the other leaves everything to his alma mater, the University of Colorado. The family wishes to dispute the validity of the second (later in time) will. What, in general, are the bases on which a will can be challenged so that it does not enter into probate?

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19.2: Trusts

Learning Objectives

- Distinguish a will from a trust, and describe how a trust is created, how it functions, and how it may come to an end.
- Compare the various kinds of trusts, as well as factors that affect both estates and trusts.

Definitions

When the legal title to certain property is held by one person while another has the use and benefit of it, a relationship known as a trust has been created. The trust developed centuries ago to get around various nuances and complexities, including taxes, of English real property law. The trustee has legal title and the beneficiary has "equitable title," since the courts of equity would enforce the obligations of the trustee to honor the terms by which the property was conveyed to him. A typical trust might provide for the trustee to manage an estate for the grantor's children, paying out income to the children until they are, say, twenty-one, at which time they would become legal owners of the property.

Trusts may be created by bequest in a will, by agreement of the parties, or by a court decree. However created, the trust is governed by a set of rules that grew out of the courts of equity. Every trust involves specific property, known as **the res** (rees; Latin for "thing"), and three parties, though the parties may be the same person.

Settlor or Grantor

Anyone who has legal capacity to make a contract may create a trust. The creator is known as the **settlor** or **grantor**. Trusts are created for many reasons; for example, so that a minor can have the use of assets without being able to dissipate them or so that a person can have a professional manage his money.

Trustee

The **trustee** is the person or legal entity that holds the legal title to the res. Banks do considerable business as trustees. If the settlor should neglect to name a trustee, the court may name one. The trustee is a fiduciary of the trust beneficiary and will be held to the highest standard of loyalty. Not even an appearance of impropriety toward the trust property will be permitted. Thus a trustee may not loan trust property to friends, to a corporation of which he is a principal, or to himself, even if he is scrupulous to account for every penny and pays the principal back with interest. The trustee must act prudently in administering the trust.

Beneficiary

The **beneficiary** is the person, institution, or other thing for which the trust has been created. Beneficiaries are not limited to one's children or close friends; an institution, a corporation, or some other organization, such as a charity, can be a beneficiary of a trust, as can one's pet dogs, cats, and the like. The beneficiary may usually sell or otherwise dispose of his interest in a trust, and that interest likewise can usually be reached by creditors. Note that the settlor may create a trust of which he is the beneficiary, just as he may create a trust of which he is the trustee.

Continental Bank & Trust Co. v. Country Club Mobile Estates, Ltd., (see Section 14.4.2), considers a basic element of trust law: the settlor's power over the property once he has created the trust.

Express Trusts

Trusts are divided into two main categories: express and implied. Express trusts include **testamentary trusts** and **inter vivos** (or living) trusts. The testamentary trust is one created by will. It becomes effective on the testator's death. The *inter vivos* trust is one created during the lifetime of the grantor. It can be revocable or irrevocable (see Figure 19.2.1 "Express Trusts").

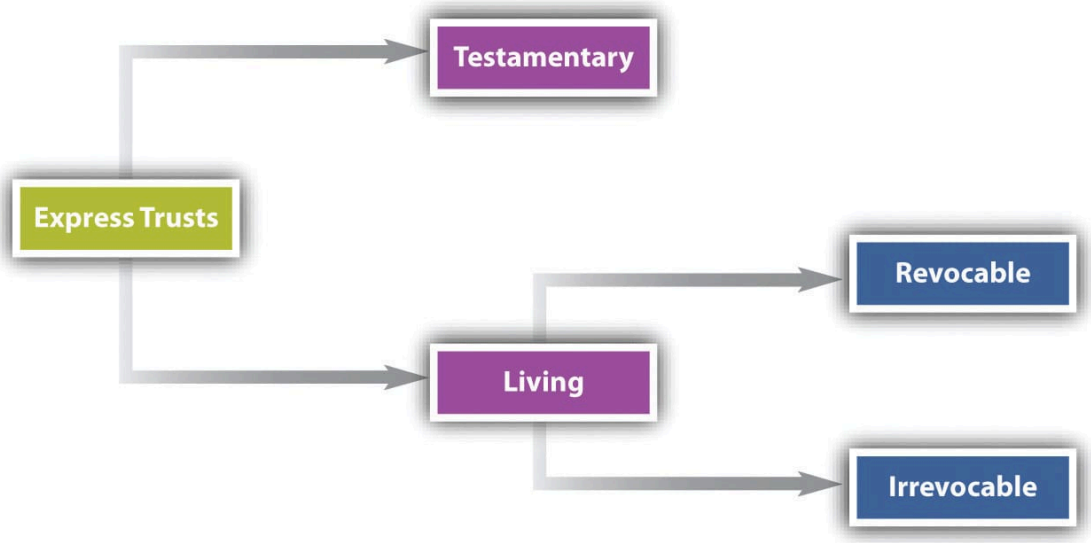


Figure 19.2.1: Express Trusts

A revocable trust is one that the settlor can terminate at his option. On termination, legal title to the trust assets returns to the settlor. Because the settlor can reassert control over the assets whenever he wishes, the income they generate is taxed to him.

By contrast, an irrevocable trust is permanent, and the settlor may not revoke or modify its terms. All income to the trust must be accumulated in the trust or be paid to the beneficiaries in accordance with the trust agreement. Because income does not go to the settlor, the irrevocable trust has important income tax advantages, even though it means permanent loss of control over the assets (beyond the instructions for its use and disposition that the settlor may lay out in the trust agreement). A hybrid form is the reversionary trust: until the end of a fixed period, the trust is irrevocable and the settlor may not modify its terms, but thereafter the trust assets revert to the settlor. The reversionary trust combines tax advantages with ultimate possession of the assets.

Of the possible types of express trusts, five are worth examining briefly: (1) Totten trusts, (2), blind trusts, (3) Clifford trusts, (4) charitable trusts, and (5) spendthrift trusts. The use of express trusts in business will also be noted.

Totten Trust

The **Totten trust**, which gets its name from a New York case, *In re Totten*, 71 N.E. 748 (N.Y. 1904), is a tentative trust created when someone deposits funds in a bank as trustee for another person as beneficiary. (Usually, the account will be named in the following form: “Mary, in trust for Ed.”) During the beneficiary’s lifetime, the grantor-depositor may withdraw funds at his discretion or revoke the trust altogether. But if the grantor-depositor dies before the beneficiary and had not revoked the trust, then the beneficiary is entitled to whatever remains in the account at the time of the depositor’s death.

Blind Trust

In a **blind trust**, the grantor transfers assets—usually stocks and bonds—to trustees who hold and manage them for the grantor as beneficiary. The trustees are not permitted to tell the grantor how they are managing the portfolio. The blind trust is used by high government officials who are required by the Ethics in Government Act of 1978 to put their assets in blind trusts or abstain from making decisions that affect any companies in which they have a financial stake. Once the trust is created, the grantor-beneficiary is forbidden from discussing financial matters with the trustees or even to give the trustees advice. All that the grantor-beneficiary sees is a quarterly statement indicating by how much the trust net worth has increased or decreased.

Clifford Trust

The **Clifford trust**, named after the settlor in a Supreme Court case, *Helvering v. Clifford*, 309 U.S. 331 (1940), is reversionary: the grantor establishes a trust irrevocable for at least ten years and a day. By so doing, the grantor shifts the tax burden to the beneficiary. So a person in a higher bracket can save considerable money by establishing a Clifford trust to benefit, say, his or her children. The tax savings will apply as long as the income from the trust is not devoted to needs of the children that the grantor is

legally required to supply. At the expiration of the express period in the trust, legal title to the res reverts to the grantor. However, the Tax Reform Act of 1986 removed the tax advantages for Clifford trusts established after March 1986. As a result, all income from such trusts is taxed to the grantor. Existing Clifford trusts were not affected by the 1986 tax law.

Charitable Trust

A **charitable trust** is one devoted to any public purpose. The definition is broad; it can encompass funds for research to conquer disease, to aid battered wives, to add to museum collections, or to permit a group to proselytize on behalf of a particular political or religious doctrine. The law in all states recognizes the benefits to be derived from encouraging charitable trusts, and states use the **cy pres** (see press; "as near as possible") doctrine to further the intent of the grantor. The most common type of trust is the charitable remainder trust. You would donate property—usually intangible property such as stock—in trust to an approved charitable organization, usually one that has tax-exempt 501(c)(3) status from the IRS. The organization serves as trustee during your life and provides you or someone you designate with a specified level of income from the property that you donated. This could be for a number of years or for your lifetime. After your death or the period that you set, the trust ends and the charitable organization owns the assets that were in the trust.

There are important tax reasons why people set up charitable trusts. The trustor gets five years' worth of tax deductions for the value of the assets in the charitable trust. Capital gains are treated favorably, as well: charitable trusts are irrevocable, which means that the person setting up the trust (the "trustor") permanently gives up control of the assets to the charitable organization. Thus, the charitable organization could sell an asset in the trust that would ordinarily incur significant capital gains taxes, but since the trustor no longer owns the asset, there is no capital gains tax: as a tax-exempt organization, the charity will not pay capital gains, either.

Spendthrift Trust

A **spendthrift trust** is established when the settlor believes that the beneficiary is not to be trusted with whatever rights she might possess to assign the income or assets of the trust. By express provision in a trust instrument, the settlor may ensure that the trustees are legally obligated to pay only income to the beneficiary; no assignment of the assets may be made, either voluntarily by the beneficiary or involuntarily by operation of law. Hence the spendthrift beneficiary cannot gamble away the trust assets nor can they be reached by creditors to pay her gambling (or other) debts.

Express Trusts in Business

In addition to their use in estate planning, **express trusts** are also created for business purposes. The business trust was popular late in the nineteenth century as a way of getting around state limitations on the corporate form and is still used today. By giving their shares to a voting trust, shareholders can ensure that their agreement to vote as a bloc will be carried out. But voting trusts can be dangerous. Agreements that result in price fixing or other restraints of trade violate the antitrust laws; for example, companies are in violation when they act collusively to fix prices by pooling voting stock under a trust agreement, as happened frequently at the turn of the century.

Implied Trusts

Trusts can be created by courts without any intent by a settlor to do so. For various reasons, a court will declare that particular property is to be held by its owner in trust for someone else. Such trusts are **implied trusts** and are usually divided into two types: constructive trusts and resulting trusts. A constructive trust is one created usually to redress a fraud or to prevent unjust enrichment. Suppose you give $1 to an agent to purchase a lottery ticket for you, but the agent buys the ticket in his own name instead and wins $1,000,000, payable into an account in amounts of $50,000 per year for twenty years. Since the agent had violated his fiduciary obligation and unjustly enriched himself, the court would impose a constructive trust on the account, and the agent would find himself holding the funds as trustee for you as beneficiary. By contrast, a resulting trust is one imposed to carry out the supposed intent of the parties. You give an agent $100,000 to purchase a house for you. Title is put in your agent's name at the closing, although it is clear that since she was paid for her services, you did not intend to give the house to her as a gift. The court would declare that the house was to be held by the agent as trustee for you during the time that it takes to have the title put in your name.

Key Takeaway

A trust can be created during the life of the settlor of the trust. A named trustee and beneficiary are required, as well as some assets that the trustee will administer. The trustee has a fiduciary duty to administer the trust with the utmost care. Inter vivos trusts can be revocable or irrevocable. Testamentary trusts are, by definition, not revocable, as they take effect on the death of the settlor.

Exercise 19.2.1

1. Karen Vreeland establishes a testamentary trust for her son, Brian, who has a gambling addiction. What kind of trust should she have established?
2. A group of ten coworkers "invests" in the Colorado Lottery when the jackpot reaches $200 million. Each puts in $10 for five tickets. Dan Connelly purchases fifty Colorado Lottery tickets on behalf of the group and holds them. As luck would have it, one of the tickets is a winner. Dan takes the ticket, claims the $200 million, quits his job, and refuses to share. Do the coworkers have any legal recourse? Was a trust created in this situation?
3. Laura Sarazen has two sisters, Lana and Linda. Laura deposits $50,000 at the Bank of America and creates an account that names her sister, Linda, in the following form: "Laura Sarazen, in trust for Linda Sarazen." Laura dies two years later and has not withdrawn funds from the bank. The executrix, Lana Sarazen, wants to include those funds in the estate. Linda wants to claim the $50,000 plus accumulated interest in addition to whatever share she gets in the will. Can she?

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19.3: Factors Affecting Estates and Trusts

Learning Objectives

1. Know how principal and income are distinguished in administering a trust.
2. Explain how estates and trusts are taxed, and the utility of powers of appointment.

Principal and Income

Often, one person is to receive income from a trust or an estate and another person, the remainderman, is to receive the remaining property when the trust or estate is terminated. In thirty-six states, a uniform act, the **Uniform Principal and Income Act (UPIA)**, defines principal and income and specifies how expenses are to be paid. If the trust agreement expressly gives the trustee power to determine what is income and what is principal, then his decision is usually unreviewable. If the agreement is silent, the trustee is bound by the provisions of the UPIA.

The general rule is that ordinary receipts are income, whereas extraordinary receipts are additions to principal. Ordinary receipts are defined as the return of money or property derived from the use of the principal, including rent, interest, and cash dividends. Extraordinary receipts include stock dividends, revenues or other proceeds from the sale or exchange of trust assets, proceeds from insurance on assets, all income accrued at the testator's death, proceeds from the sale or redemption of bonds, and awards or judgments received in satisfaction of injuries to the trust property. Expenses or obligations incurred in producing or preserving income—including ordinary repairs and ordinary taxes—are chargeable to income. Expenses incurred in making permanent improvements to the property, in investing the assets, and in selling or purchasing trust property are chargeable to principal, as are all obligations incurred before the decedent's death.

Taxation

Estates and trusts are taxable entities under the federal income tax statute. The general rule is that all income paid out to the beneficiaries is taxable to the beneficiaries and may be deducted from the trust's or estate's gross income in arriving at its net taxable income. The trust or estate is then taxed on the balance left over—that is, on any amounts accumulated. This is known as the conduit rule, because the trust or estate is seen as a conduit for the income.

Power of Appointment

A **power of appointment** is the authority given by one person (the donor) to another (the donee) to dispose of the donor's property according to whatever instructions the donor provides. A power of appointment can be created in a will, in a trust, or in some other writing. The writing may imply the power of appointment rather than specifically calling it a power of appointment. For example, a devise or bequest of property to a person that allows that person to receive it or transfer it gives that person a power of appointment. The person giving the power is the donor, and the person receiving it is the donee.

There are three classes of powers of appointment. General powers of appointment give donees the power to dispose of the property in any way they see fit. Limited powers of appointment, also known as special powers of appointment, give donees the power to transfer the property to a specified class of persons identified in the instrument creating the power. Testamentary powers of appointment are powers of appointment that typically are created by wills.

If properly used, the power of appointment is an important tool, because it permits the donee to react flexibly to circumstances that the donor could not have foreseen. Suppose you desire to benefit your children when they are thirty-five or forty according to whether they are wealthy or poor. The poorer children will be given more from the estate or trust than the wealthier ones. Since you will not know when you write the will or establish the trust which children will be poorer, a donee with a power of appointment will be able to make judgments impossible for the donor to make years or decades before.

Key Takeaway

Administering either an estate or a trust requires knowing the distinction between principal and income in a variety of situations. For example, knowing which receipts are ordinary and which are extraordinary is essential to knowing whether to allocate the receipts as income or as an addition to principal. Knowing which expenses are chargeable to principal and which are chargeable to income is also important. Both estates and trusts are taxable entities, subject to federal and state laws on estate and trust taxation. Powers of appointment can be used in both trusts and estates in order to give flexibility to named donees.

Exercise 19.3.1

1. In his will, Hagrid leaves his pet dragon, Norberta, to Ron Weasley as donee with power of appointment. He intends to restrict Ron's power as donee to give or sell Norberta only to wizards or witches. What kind of power of appointment should Hagrid use?
2. In a testamentary trust, Baxter Black leaves Hilda Garde both real and personal property to administer as she sees fit as trustee "for the benefit of the Michigan Militia." Hilda intends to sell the house, but meanwhile she rents it out at $1,200 a month and incurs repairs to the property to prepare it for sale in the amount of $4,328.45. Is the expense chargeable to income or principal? Is the rent to be characterized as ordinary receipts or extraordinary receipts?

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19.4: Cases

Testamentary Capacity

Estate of Seymour M. Rosen

Supreme Judicial Court of Maine

447 A.2d 1220 (1982)

GODFREY, JUSTICE

Phoebe Rosen and Jeffrey Rosen, widow and son of the decedent, Seymour M. Rosen, appeal from an order of the Knox County Probate Court admitting the decedent's will to probate. Appellants argue that the decedent lacked the testamentary capacity necessary to execute a valid will and that the Probate Court's finding that he did have the necessary capacity is clearly erroneous. On direct appeal from the Probate Court pursuant to section 1-308 of the Probate Code (18-A M.R.S.A. § 1-308), this Court reviews for clear error the findings of fact by the Probate Court. (*Estate of Mitchell*, Me., 443 A.2d 961 (1982)). We affirm the judgment.

Decedent, a certified public accountant, had an accounting practice in New York City, where he had been married to Phoebe for about thirty years. Their son, Jeffrey, works in New York City. In 1973, the decedent was diagnosed as having chronic lymphatic leukemia, a disease that, as it progresses, seriously impairs the body's ability to fight infection. From 1973 on, he understood that he might die within six months. In June, 1978, he left his home and practice and moved to Maine with his secretary of two months, Robin Gordon, the appellee. He set up an accounting practice in Camden.

The leukemia progressed. The decedent was on medication and was periodically hospitalized for infections, sometimes involving septic shock, a condition described by the treating physician as akin to blood poisoning. The infections were treated with antibiotics with varying degrees of success. Despite his medical problems, the decedent continued his accounting practice, working usually three days a week, until about two months before his death on December 4, 1980. Robin Gordon lived with him and attended him until his death.

While living in New York, the decedent had executed a will leaving everything to his wife or, if she should not survive him, to his son. In November, 1979, decedent employed the services of Steven Peterson, a lawyer whose office was in the same building as decedent's, to execute a codicil to the New York will leaving all his Maine property to Robin. At about this time, decedent negotiated a property settlement with his wife, who is now living in Florida. He executed the will at issue in this proceeding on July 25, 1980, shortly after a stay in the hospital with a number of infections, and shortly before a hospitalization that marked the beginning of the decedent's final decline. This will, which revoked all earlier wills and codicils, left all his property, wherever located, to Robin, or to Jeffrey if Robin did not survive him.

The court admitted the 1980 will to probate over the objections of Phoebe and son, making extensive findings to support its conclusion that "the decedent clearly had testamentary capacity when he executed his Will."

The Probate Court applied the standard heretofore declared by this Court for determining whether a decedent had the mental competence necessary to execute a valid will:

A 'disposing mind' involves the exercise of so much mind and memory as would enable a person to transact common and simple kinds of business with that intelligence which belongs to the weakest class of sound minds; and a disposing memory exists when one can recall the general nature, condition and extent of his property, and his relations to those to whom he gives, and also to those from whom he excludes, his bounty. He must have active memory enough to bring to his mind the nature and particulars of the business to be transacted, and mental power enough to appreciate them, and act with sense and judgment in regard to them. He must have sufficient capacity to comprehend the condition of his property, his relations to the persons who were or should have been the objects of his bounty, and the scope and bearing of the provisions of his will. He must have sufficient active memory to collect in his mind, without prompting, the particulars or elements of the business to be transacted, and to hold them in his mind a sufficient length of time to perceive at least their obvious relations to each other, and be able to form some rational judgment in relation to them.

In re Leonard, Me., 321 A.2d 486, 488-89 (1974), *quoting Hall v. Perry*, 87 Me. 569, 572, 33 A. 160, 161 (1895).

Appellants portray the decedent as “a man ravaged by cancer and dulled by medication,” and it is true that some evidence in the record tends to support this characterization. However, the law as set out in *In re Leonard* requires only a modest level of competence (“the weakest class of sound minds”), and there is considerable evidence of record that the decedent had at least that level of mental ability and probably more:

1. The three women who witnessed the will all testified that decedent was of sound mind. They worked in the same building as the decedent, knew him, and saw him regularly. Such testimony is admissible to show testamentary capacity. (*In re Leonard*, 321 A.2d at 489).
2. Lawyer Peterson, who saw the decedent daily, testified that he was of sound mind. Peterson used the decedent as a tax adviser, and the decedent did accounting work for Peterson’s clients. Peterson had confidence in the decedent’s tax abilities and left the tax aspects of the will to the decedent’s own consideration.
3. Dr. Weaver, the treating physician, testified that although the decedent would be mentally deadened for a day or two while in shock in the hospital, he would then regain “normal mental function.” Though on medication, the decedent was able to conduct his business until soon before his death. Dr. Weaver testified without objection that on one occasion he had offered a written opinion that the decedent was of sound mind.

Appellants’ principal objection to the will is that the decedent lacked the necessary knowledge of “the general nature, condition and extent of his property.” (*In re Leonard*, 321 A.2d at 488). The record contains testimony of Robin Gordon and lawyer Peterson that decedent did not know what his assets were or their value. However, there is other evidence, chiefly Peterson’s testimony about his discussions with the decedent preliminary to the drafting of the 1980 will and, earlier, when the 1979 codicil to the New York will was being prepared, that the decedent did have knowledge of the contents of his estate. He knew that he had had a Florida condominium, although he was unsure whether this had been turned over to his wife as part of the recent property settlement; he knew that he had an interest in an oil partnership, and, although he was unable to place a value on that interest, he knew the name of an individual who could supply further information about it; he knew he had stocks and bonds, two motor vehicles, an account at the Camden National Bank, and accounts receivable from his accounting practice.

The law does not require that a testator’s knowledge of his estate be highly specific in order for him to execute a valid will. It requires only that the decedent be able to recall “the general nature, condition and extent of his property.” (*In re Leonard*, 321 A.2d at 488). Such knowledge of one’s property is an aspect of mental soundness, not an independent legal requirement as the appellants seem to suggest. Here, there was competent evidence that the decedent had a general knowledge of his estate. The Probate Court was justified in concluding that, in the circumstances, the decedent’s ignorance of the precise extent of his property did not establish his mental incompetence. The decedent’s uncertainty about his property was understandable in view of the fact that some of his property had been transferred to his wife in the recent property negotiations in circumstances rendering it possible that the decedent might have wanted to put the matter out of his mind. Also, there was evidence from which the court could have inferred that much of the property was of uncertain or changing value.

On the evidence of record, this Court cannot hold that the findings of the Probate Court were clearly erroneous. Where, as here, there is a choice between two permissible views of the weight of the evidence, the findings of the Probate Court must stand. *Estate of Mitchell*, Me., 443 A.2d 961 (1982).

Case Questions 19.4.1

1. Based on what is written in this opinion, did the decedent’s widow get nothing as a result of her husband’s death? What did she get, and how?
2. If Phoebe Rosen’s appeal had resulted in a reversal of the probate court, what would happen?
3. Is it possible that Seymour Rosen lacked testamentary capacity? Could the probate court have ruled that he did and refuse to admit the will to probate? If so, what would happen, using the court’s language and cited opinions?

Settlor’s Limited Power over the Trust

Continental Bank & Trust Co. v. Country Club Mobile Estates, Ltd.

632 P.2d 869 (Utah 1981)

Oaks, Justice

The issue in this appeal is whether a settlor who has created a trust by conveying property that is subject to an option to sell can thereafter extend the period of the option without the participation or consent of the trustee. We hold that he cannot. For ease of reference, this opinion will refer to the plaintiff-appellant, Continental Bank & Trust Co., as the "trustee," to defendant-respondent, Country Club Mobile Estates, Ltd., as the "lessee-optionee," and to Marshall E. Huffaker, deceased, as the "settlor."

The sequence of events is critical. On September 29, 1965, the settlor gave the lessee-optionee a fifty-year lease and an option to purchase, during the sixth year of the lease, the 31 acres of land at issue in this litigation. On March 1, 1971, the settlor granted the lessee-optionee a five-year extension of its option, to September 29, 1976. On December 6, 1973, the settlor conveyed the subject property to the trustee in trust for various members of his family, signing a trust agreement and conveying the property to the trustee by a warranty deed, which was promptly recorded. The lessee-optionee had actual as well as constructive notice of the creation of this trust by at least April, 1975, when it began making its monthly lease payments directly to the trustee. On March 1, 1976, the settlor signed an instrument purporting to grant the lessee-optionee another five-year extension of its option, to September 29, 1981. The trustee was unaware of this action and did not participate in it. On October 30, 1978, approximately one week after the settlor's death, the trustee learned of the March 1, 1976, attempted extension and demanded and obtained a copy of the instrument.

On July 3, 1979, the trustee brought this action against the lessee-optionee and other interested parties to quiet title to the 31 acres of trust property and to determine the validity of the attempted extension of the option. Both parties moved for summary judgment on the issue of the validity of the extended option. The district court denied the trustee's motion and granted the lessee-optionee's motion, and the trustee appealed. We reverse.

A settlor admittedly could reserve power to extend the duration of an option on trust property, and do so without the consent or involvement of the trustee. The question is whether this settlor did so. The issue turns on the terms of the trust instrument, which, in this case, gave the trustee broad powers, including the power to grant options, but also reserved to the settlor the right to revoke the trust or to direct the trustee to sell trust property. The relevant clauses are as follows:

ARTICLE IV.

To carry out the Trust purposes of the Trust created hereby...the Trustee is vested with the following powers...:

B. To manage, control, sell, convey...; to grant options...

K....The enumeration of certain powers of the Trustee herein shall not be construed as a limitation of the Trustee's power, it being intended that the Trustee shall have all rights, powers and privileges that an absolute owner of the property would have.

ARTICLE V.

The Trustor by an instrument in writing filed with the Trustee may modify, alter or revoke this Agreement in whole or in part, and may withdraw any property subject to the agreement;...

There is hereby reserved to the Trustor the power to direct the trustee, in writing, from time to time, to retain, sell, exchange or lease any property of the trust estate....Upon receipt of such directions, the Trustee shall comply therewith. The lessee-optionee argues, and the district court held, that in the foregoing provisions of the trust agreement the settlor reserved the power to direct the trustee in regard to the leased property, and that the effect of his executing the extension of the option on March 1, 1976, was to direct the trustee to sell the property to the lessee-optionee upon its exercise of the option. We disagree. We are unable to find an exercise of the "power to direct the trustee, in writing," in an act that was not intended to communicate and did not in fact communicate anything to the trustee. We are likewise unable to construe the extension agreement signed by the settlor and the lessee-optionee as "an instrument in writing filed with the Trustee" to "modify, alter or revoke this Agreement...." Nor can we agree with the dissent's argument for "liberal construction...to the reserved powers of a settlor" in a trust agreement which expressly vests **the trustee** with the power "to grant options" and explicitly states its intention that **the trustee** "shall have all rights, powers and privileges that an absolute owner of the property would have." Article IV, quoted above. (emphases in original)

A trust is a form of ownership in which the legal title to property is vested in a trustee, who has equitable duties to hold and manage it for the benefit of the beneficiaries. *Restatement of Trusts, Second*, § 2 (1959). It is therefore axiomatic in trust law that the trustee under a valid trust deed has exclusive control of the trust property, subject only to the limitations imposed by law or the trust instrument, and that once the settlor has created the trust he is no longer the owner of the trust property and has only such ability to deal with it as is expressly reserved to him in the trust instrument. (*Boone v. Davis*, 64 Miss. 133, 8 So. 202 (1886); *Marvin v. Smith*, 46 N.Y. 571 (1871)). As stated in Bogert, *Trusts & Trustees*, §42 (2d ed. 1965):

After a settlor has completed the creation of a trust he is, with small exceptions noted below, and except as expressly provided otherwise by the trust instrument or by statute, not in any legal relationship with the beneficiaries or the trustee, and has no liabilities or powers with regard to the trust administration.

None of the exceptions identified by Bogert applies in this case.

This is a case where a settlor created a trust and then chose to ignore it. He could have modified or revoked the trust, or directed the trustee in writing to sell or lease the trust property, but he took neither of these actions. Instead, more than two years after the creation and recording of the trust, and without any direction or notice to the trustee, the settlor gave the lessee-optionee a signed instrument purporting to extend its option to buy the trust property for another five years. The trustee did not learn of this instrument until two and one-half years later, immediately following the death of the settlor.

An extension of the option to buy would obviously have a limiting effect on the value of the reversion owned by the trust (and thus on the rights of the trust beneficiaries), which the trustee has a duty to protect. Even a revocable trust clothes beneficiaries, for the duration of the trust, with a legally enforceable right to insist that the terms of the trust be adhered to. If we gave legal effect to the settlor's extension of this option in contravention of the existence and terms of the trust, we would prejudice the interests of the beneficiaries, blur some fundamental principles of trust law, and cast doubt upon whether it is the trustee or the settlor who is empowered to manage and dispose of the trust property in a valid revocable trust.

The judgment of the district court is reversed and the cause is remanded with instructions to enter judgment for the plaintiff. Costs to appellant.

HOWE, Justice: (Dissenting)

I dissent. The majority opinion has overlooked the cardinal principle of construction of a trust agreement which is that the settlor's intent should be followed. See *Leggroan v. Zion's Savings Bank & Trust Co.*, 120 Utah 93, 232 P.2d 746 (1951). Instead, the majority places a strict and rigid interpretation on the language of the trust agreement which defeats the settlor's intent and denies him an important power he specifically reserved to himself. All of this is done in a fact situation where there is no adverse interest asserted and no one will be prejudiced in any way by following the undisputed and obvious intent of the settlor.

Unlike the situation found with many trusts, Huffaker in establishing his trust reserved to himself broad powers in Article V.:

ARTICLE V.

The Trustor by an instrument in writing filed with the Trustee *may modify, alter or revoke this Agreement* in whole or in part, and *may withdraw any property subject to the Agreement*; Provided, however, that the duties, powers and limitations of the Trustee shall not be substantially changed without its written consent, except as to revocation or withdrawal. (emphasis added)

* * * *

There is hereby reserved to the Trustor the power to *direct the trustee, in writing,* from time to time, *to retain, sell, exchange or lease any property of the Trust estate*, to invest Trust funds, or to purchase for the Trust any property which they [sic] may designate and which is acceptable to the Trustee. *Upon receipt of such directions, the Trustee shall comply therewith*. (emphasis added)

Thus while Huffaker committed the property into the management and control of the trustee, he retained the right in Article V. to direct the trustee from time to time with regard to the property, and the trustee agreed that upon receipt of any such directions it would comply. It is significant that the consent of the trustee was not required. These broad reserved powers in effect gave him greater power over the property than the trustee possessed since he had the final word.

The property in question was subject to defendant's option when it was placed in trust. The trustee took title subject to that option and subject to future directions from Huffaker. The extension granted by Huffaker to the defendant was in effect a directive that the trustee sell the property to the defendant if and when it elected to purchase the property. At that time, the defendant could deliver the directive to the trustee which held legal title and the sale could be consummated. Contrary to what is said in the majority opinion, the extension was intended to communicate and did communicate to the trustee the settlor's intention to sell to the defendant. The trustee does not claim to have any doubt as to what the settlor intended.

There was no requirement in the trust agreement as to when the directive to sell had to be delivered to the trustee nor was there any requirement that the settlor must himself deliver the direction to sell to the trustee rather than the buyer deliver it.

The majority opinion concedes that Huffaker had the power to extend the option but denies him that power because he did not communicate his intention to exercise that power to the trustee at the time he extended the option. It ignores the fact that the lessee had five years to decide whether it wanted to buy the property, at which time it could deliver the direction to sell to the trustee. The majority opinion reads into the trust agreement rigidity and strictness which is unwarranted.

The majority opinion contains a quote from Bogert, *Trust and Trustees*, § 42, for authority that after a settlor has completed the creation of a trust he is not in any legal relationship with the beneficiaries or the trustee, and has no liabilities or power with regard to the trust administration. However, as will be seen in that quote, it is there recognized that those rules do not apply where it has been expressly provided otherwise by the trust instrument. Such is the case here where the settlor reserved extensive powers and was himself the primary beneficiary.

Huffaker's extension agreement apparently would not have been challenged by his trustee if he had given written directions to the trustee to extend the option instead of executing the extension with the defendant himself, and apparently would not have been challenged had he not died. Yet, although the trustee did not itself extend the option nor receive a copy of the agreement until after Huffaker's death, it had not in the meantime dealt with third parties concerning the property or made any commitments that were inconsistent with Huffaker's action. Since there were no intervening third-party rights and it is not unfair to the trust beneficiaries to require them to abide by the intention of their donor and benefactor, I see no justification for the refusal of the trustee to accept the extension agreement as a valid direction to sell the property as provided for by the terms of the trust. This is not a case where the trustee in ignorance of the action of the settlor in granting an option had also granted an option or dealt with the property in a manner inconsistent with the actions of the settlor so that there are conflicting claims of innocent third-parties presented. In such a case there would be some justification for applying a strict construction so that there can be orderliness in trust administration. After all, the reason for the provisions of the trust agreement defining the powers of the trustee and the reserved powers of the settlor was to provide for the exercise of those powers in a manner that would be orderly and without collision between the trustee and settlor. In the instant case the trustee has not even suggested how it will be prejudiced by following Huffaker's directions. The majority opinion makes reference to protecting the interest of the contingent beneficiaries but overlooks that Huffaker was not only the settlor but also the primary beneficiary both when the trust was established and when the option was extended.

The majority opinion treats the relationship between Huffaker and his trustee as an adversary relationship instead of recognizing that the trustee was Huffaker's fiduciary to *assist* him in managing *his* property. Therefore, there is no reason to construe the trust agreement as if it were meant to deal with a relationship between two adverse parties.

My view that a liberal construction should be given to the reserved powers of a settlor under these circumstances finds support in a decision of the Supreme Judicial Court of Massachusetts, *Trager v. Schwartz*, 345 Mass. 653, 189 N.E.2d 509 (1963). There the settlor on July 15, 1942, executed as donor a declaration of trust. The property was 65 shares of stock and 4 lots of land. In that instrument he reserved the right to alter, amend or revoke the instrument in whole or in part. However, it was specifically provided in the declaration of trust that "any such alterations, amendments or revocations of this trust shall be by an instrument in writing signed by the donor, and shall become effective only upon being recorded in the South District Registry of Deeds for Middlesex County."

Later, on February 4, 1954, the trustor executed a document entitled "Modification and Amendment of Trust" whereby he withdrew the 65 shares of stock from the trust and sold them to his son and told him that he had arranged for the recording of that instrument by his lawyer. However, he did not record the document nor instruct his attorney to do so. On August 25, 1960, the settlor executed a document entitled "Revocation of Declaration of Trust," in which he revoked in whole the declaration of trust of July 15, 1942. This revocation was recorded on August 26th. He thereupon directed the trustees to deliver to him the 65 shares of stock and the 4 lots of real estate. His son received notice of the revocation on August 30, 1960, and recorded the following day the modification and amendment dated February 4, 1954, by which he had obtained the 165 shares of stock.

In a suit brought by the settlor to regain ownership of the stock, he contended that the recording of his complete revocation on August 26, 1960, rendered ineffective the recording of the partial revocation on August 31, 1960. He relied upon the principle that "A valid trust once created cannot be revoked or altered except by the exercise of a reserve power to do so, which must be exercised in strict conformity to its terms." The court upheld the earlier sale of stock stating:

The provision of the declaration of trust that amendments and revocations 'shall become effective only upon being recorded' shall not be interpreted, where there are no intervening rights of third-parties, as preventing the carrying out of the earlier amendment once it has been recorded. This should be the result, particularly where there was an express undertaking by one of the parties to see to the recording.

In the instant case, defendant will be greatly prejudiced, and the settlor's intention thwarted, as a result of following the majority

opinion's interpretation of the trust terms as they relate to a written direction to the trustee to sell trust property. Defendant gave up the opportunity to purchase the property within the original option period in reliance on Huffaker's execution of the extension agreement, a document prepared by his attorney. I am not persuaded that because defendant was making its rental payments to the trustee it was unreasonable in obtaining the extension of the option, which previously had been granted it by Huffaker, to again deal with him and rely on him since he was the final power respecting his property, and since neither he nor his attorney who had full and complete knowledge of the trust apparently raised any question as to the propriety of what they were doing. Just as the settlor in *Trager v. Schwartz*, supra, was not permitted to gain advantage by his failure to record as required by the trust agreement, I think the settlor's beneficiaries in the instant case should not gain by Huffaker's omissions and to the extreme prejudice of defendant.

The trustee has based its arguments on cases and principles that are distinguishable or inapplicable to the instant case. It regards the trust agreement as expressly allowing only it, as trustee and holder of the legal title to the property, to sell, option, or otherwise dispose of it. But the language of the trust regarding powers retained by Huffaker is inclusive enough to encompass his action in this case, for he expressly retained the right to direct the plaintiff to sell the property, a right that is compatible with his granting of the option extension.

The trustee also asserts that the written instrument received after Huffaker's death was ineffective as a directive to the trustee. Plaintiff cites authority for the principle that a revocable trust can only be modified during the settlor's lifetime, e.g., *Chase National Bank of City of N.Y. v. Tomagno*, 172 Misc. 63, 14 N.Y.S.2d 759 (1939). We are not dealing with an attempted testamentary disposition in this case, however. The option extension agreement was executed during Huffaker's lifetime, and the fact that it was received by plaintiff only after he died does not deprive it of its effect.

I would affirm the judgment below.

Case Questions 19.4.2

1. Does the decision effectively deprive Country Club Mobile Estates, Ltd. of anything? What?
2. Why would the trustee (Continental Bank & Trust Co.) object to giving Country Club Mobile Estates, Ltd. another two and a half years on the lease?
3. Which opinion seems better reasoned—the majority or the dissent? Why do you think so?

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19.5: Summary and Exercises

Summary

Estate planning is the process by which an owner decides how her property is to be passed on to others. The four basic estate planning tools are wills, trusts, gifts, and joint ownership. In this chapter, we examined wills and trusts. A will is the declaration of a person's wishes about the disposition of her assets on her death. The law of each state sets forth certain formalities, such as the number of witnesses, to which written wills must adhere. Wills are managed through the probate process, which varies from state to state, although many states have now adopted the Uniform Probate Code. In general, anyone over eighteen and of sound mind may make a will. It must be signed by the testator, and two or three others must witness the signature. A will may always be modified or revoked during the testator's lifetime, either expressly through a codicil or through certain actions, such as a subsequent marriage and the birth of children, not contemplated by the will. Wills must be carefully drafted to avoid abatement and ademption. The law provides for distribution in the case of intestacy. The rules vary from state to state and depend on whether the decedent was married when she died, had children or parents who survived her, or had collateral heirs.

Once a will is admitted to probate, the personal representative must assemble and inventory all assets, have them appraised, handle claims against the estate, pay taxes, prepare a final accounting, and only then distribute the assets according to the will.

A trust is a relationship in which one person holds legal title to certain property and another person has the use and benefit of it. The settlor or grantor creates the trust, giving specific property (the res) to the trustee for the benefit of the beneficiary. Trusts may be living or testamentary, revocable or irrevocable. Express trusts come in many forms, including Totten trusts, blind trusts, Clifford trusts, charitable trusts, and spendthrift trusts. Trusts may also be imposed by law; constructive and resulting trusts are designed to redress frauds, prevent unjust enrichment, or see to it that the intent of the parties is carried out.

Exercises 19.5.1

1. Seymour deposits $50,000 in a bank account, ownership of which is specified as "Seymour, in trust for Fifi." What type of trust is this? Who is the settlor? The beneficiary? The trustee? May Seymour spend the money on himself? When Seymour dies, does the property pass under the laws of intestacy, assuming he has no will?
2. Seymour, a resident of Rhode Island, signed a will in which he left all his property to his close friend, Fifi. Seymour and Fifi then moved to Alabama, where Seymour eventually died. Seymour's wife Hildegarde, who stayed behind in Rhode Island and who was not named in the will, claimed that the will was revoked when Seymour moved from one state to another. Is she correct? Why?
3. Assume in Exercise 2 that Seymour's Rhode Island will is valid in Alabama. Is Hildegarde entitled to a part of Seymour's estate? Explain.
4. Assume in Exercise 2 that Seymour's Rhode Island will is valid in Alabama. Seymour and Hildegarde own, as tenants by the entirety, a cottage on the ocean. In the will, Seymour specifically states that the cottage goes to Fifi on his death. Does Fifi or Hildegarde get the cottage? Or do they share it? Explain?
5. Assume in Exercise 2 that Seymour's Rhode Island will is not valid. Seymour's only relative besides Hildegarde is his nephew, Chauncey, whom Seymour detests. Who is entitled to Seymour's property when he dies—Fifi, Hildegarde, or Chauncey? Explain.
6. Scrooge is in a high tax bracket. He has set aside in a savings account $100,000, which he eventually wants to use to pay the college expenses of his tiny son, Tim, who is three. The account earns $10,000 a year, of which $5,000 goes to the government in taxes. How could Scrooge lower the tax payments while retaining control of the $100,000?
7. Assume in Exercise 6 that Scrooge considers placing the $100,000 in trust for Tim. But he is worried that when Tim comes of age, he might sell his interest in the trust. Could the trust be structured to avoid this possibility? Explain.
8. Assume that Scrooge has a substantial estate and no relatives. Is there any reason for him to consider a will or trust? Why? If he dies without a will, what will happen to his property?

Self-Test Questions 19.5.1

1. A will written by the testator's hand and not witnessed is called

a. a conditional will
b. a nuncupative will
c. a holographic will
d. a reciprocal will

2. A written modification or supplement to a prior will is called
   a. a revocation clause
   b. an abatement
   c. a codicil
   d. none of the above
3. A trust created by will is called
   a. an inter vivos trust
   b. a reversionary trust
   c. a Totten trust
   d. a testamentary trust
4. Trustees are not permitted to tell the grantor how they are managing their portfolio of assets in
   a. a Clifford trust
   b. a spendthrift trust
   c. a blind trust
   d. a voting trust
5. An example of an implied trust is
   a. a spendthrift trust
   b. a Clifford trust
   c. a resulting trust
   d. none of the above

Answers available at the end of this section.

Answers

Self-Test Questions 19.5.1

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

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