BUS 340: BUSINESS LAW



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BUS 340: Business Law

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Licensing

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

CHAPTER OVERVIEW

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1.1: Chapter Introduction

Learning Objectives

After reading this chapter, you should be able to understand the nature and sources of law, and the concept of the rule of law and how it affects business and economic prosperity. At the conclusion of this chapter, you should be able to answer the following questions:

- What is the law?
- Where does our law come from?
- What is a rule of law?
- How is the law relevant to business?
- How does the study of the legal environment of business create a foundation for future business courses?

You might be wondering what the law has to do with you. You try to follow the rules. You don't get into any trouble. You want to engage in honest dealings in business. Besides, you can always hire an attorney if you need legal help.

This may all be true. However, it is imperative for those in the business world to understand the legal environment in which they are operating. While you may have the best intentions and be truly diligent in your efforts to do business fairly, inevitably conflicts will arise in everyday business dealings. For example, what does it mean to do business "fairly"? Fair to whom? Fair to your shareholders? Fair to your employees? Fair to the consumers who will purchase your products? Through which ethical lens will you contemplate these issues? Trade-offs are a part of business. If you want to increase shareholder profits, you may need to reduce labor costs. One way to reduce labor costs is to use cheaper labor. If you pay your employees less, your employees will be less well off, but your shareholders may be happier.

Consider the credit crisis that came to the world's attention in October 2008 and nearly toppled the U.S. economy into depression. Hundreds of thousands of homes were foreclosed by banks (Figure 1.1.1 "The Credit Crisis"), leading to a vicious cycle of depressed housing prices, shattered consumer confidence, and business retrenchment. You may be thinking that this has little to do with you or with the study of the legal environment of business. Think again. The credit crisis affected everyone. And the nature of the crisis implicated several legal environment issues.



Figure 1.1.1: The Credit Crisis. Source: Photo courtesy of Brendel, http://en.Wikipedia.org/wiki/File:Foreclosedhome.JPG.

In a nutshell, the U.S. financial system nearly collapsed under the weight of high default rates among mortgagees, the issuance of excessive subprime mortgages to unqualified debtors, collateralized debt obligations (CDOs) that were not being serviced and could not be sold, and a mortgage banking system with flawed incentive structures from the bottom to the top. The mortgage

industry created incentives for those who worked in that industry to act in their own self-interest to make a profit, even at the expense of the long-term health of the institutions for which they were working.

Considering this flawed incentive system, the results were not surprising to many economists, who know that people tend to act in their own self-interest, even at the expense of their institutions' goals. Mortgage brokers had very strong incentives to approve every mortgage applicant, regardless of creditworthiness or ability to service the mortgage. This was because the lenders were pressuring them for more mortgages, so that the lenders themselves could sell those mortgages for a profit. And this pressure for "more" was endemic at every level of the mortgage industry, from the would-be homeowner who wanted more house than he or she could afford to the investment bankers who wanted more CDOs on which they could profit. However, excessive risk was undertaken, and when mortgagees began defaulting on their mortgages, the market became flooded with houses that had been foreclosed. As the supply of houses increased and the demand for them fell, housing prices plummeted, which meant that not only were the investors not receiving income on their investments, but also homeowners were losing the value of their investments, since their house prices were plummeting. The end result was that many homeowners were "upside-down" on their obligations, meaning that they owed more on their houses than what the houses were worth. This created an incentive for mortgagees to abandon their debt obligations. When the investors did not receive income on their investments, they also were not receiving the cash flow to cover their debts, and they could not service their obligations under their CDOs. Parties at every level began clamoring for protection from their creditors from the U.S. bankruptcy courts by filing petitions for bankruptcy.

Hyperlink: Credit Crisis

vimeo.com/3261363

This video explains the credit crisis and will help you begin thinking about the intersection between the legal environment of business and the role of government in regulating business.

After watching the video in "Hyperlink: Credit Crisis", consider the intersection between law and economics. Former Federal Reserve Chairman Alan Greenspan had consistently maintained that private regulation (that is, self-regulation by private industry) was better at containing risk than government regulation. But when the 2008 credit crisis manifested, Greenspan retracted this belief, at least in part. He expressed that he was in "a state of shocked disbelief" concerning the financial institutions' inabilities to self-regulate. Brian Knowlton and Michael M. Grynbaum, "Greenspan 'Shocked' That Free Markets Are Flawed," *New York Times*, October 23, 2008, http://www.nytimes.com/2008/10/23/business/worldbusiness/23iht-gspan.4.17206624.html (accessed August 18, 2010). He always believed that the incentive of survival of the institution itself would force banks to self-regulate. However, this "shocked disbelief" underscored a fissure within the discipline of economics—namely, whether the same economic principles that apply to individuals also apply to organizations. While we know from our study of economics that individuals act in their own self-interest, the 2008 credit crisis perhaps illustrated that people continue to act in their own self-interest, even when working within a firm. The firm itself is only a collection of individual people, and so the firm itself does not act in any type of organizational self-interest.

You might be wondering why we are discussing economics. This is because economic principles are intertwined with economic prosperity, and economic prosperity is intertwined with business, as the preceding example illustrates. To understand what happened in the credit crisis and, more importantly, how to prevent something like this from happening in the future, we have to understand economic principles that impel behavior. Additionally, we have to understand how our laws can embody the knowledge that we have from economics to prevent situations like this from happening in the future. Specifically, while a basic principle of economics is that individuals act in their own self-interest, they do so within the rules of the game. That is, they do so within the parameters of the law. Additionally, sometimes individuals weigh the penalties of violating the law against the chances of getting caught to determine how they should behave. In both instances, the law is a restraint on behavior.

Reflect on the credit crisis and how our laws could have entirely averted or seriously mitigated the fallout that resulted from it. For example, if the laws regulated the incentive structures that exist within private industry, the individual incentive to make a profit would not have been allowed to overtake the financial institutions' need to self-preserve by limiting risk. Likewise, if our banking regulations limited the types of services that banks could offer, perhaps the exotic financial instruments that were created as a precursor to the credit crisis would not have been permitted in the first place. If the size of our financial institutions had been limited by law, the dangerous fallacy that the financial institutions were too large to fail could not have been perpetuated. If

compensation packages were legally restricted by limitations on size or severed from linkages to performance, then individual incentives to maximize profit could have been restrained. Additionally, this situation raises several ethics questions. For example, was it ethical to loan money to people who were not able to service those debts?

As you think about these questions and the many other questions that will arise during your study of the legal environment of business, try to set aside any fixed ideas that you have already formulated about law and the legal system. Many students who are new to the study of law find themselves sharply swayed by a particular type of fiction that has grown around the legal system. Specifically, many students find that they harbor a sense of repugnance to law, because they have heard that it is filled with frivolous lawsuits brought by a litigious public waiting to pounce at the smallest slight, along with money-grubbing attorneys waiting to cash in. We ask that you set aside those and any other preconceived notions that you may harbor about the law and the legal system. The law is a dynamic, sophisticated field. Frivolous lawsuits are not permitted to advance in our legal system, and most attorneys are committed to justice and fairness. They work hard to protect their clients' legal interests and simply do not have the desire or the time to pursue frivolous claims. Indeed, there is no incentive for them to pursue such claims, because our legal system does not reward such behavior.

Most people want to conduct themselves and their business dealings within the parameters of the law. Even if we are very cynical, barring any other compunction to behave well, we can see that it makes the most economic sense to do so. Following the rules of the game saves us money, time, and aggravation, and it preserves our individual and professional reputations. So if most people recognize that they have an incentive not to run afoul of the law, why are there so many legal disputes? There are many reasons for this, such as the fact that many of our laws are ambiguous, and reasonable people may disagree about what is "right." Additionally, legal injuries happen even under the best of conditions, and the aggrieved parties need a method to press their claims to be compensated for their damages.

A common theme in the study of the legal environment is responsibility. Much of our legal wrangling seeks to answer the questions, "Who is responsible, and what should be done about this injury?" Additionally, and perhaps more importantly for business, is the concern of how to limit liability exposure in the first place. A solid understanding of the legal environment of business should help limit the risk of liability and thus avoid legal disputes. Moreover, it should help you recognize when you need to contact your attorney for assistance in defining the contours of the law, which are the rules of the game. The law provides continuity and a reasonable expectation of how things will be, based on how they have been in the past. It provides predictability and stability.

This book does not teach you how to practice law or to conduct legal research. That is the work of attorneys. Legal research is a sophisticated method of research that seeks to determine the current state of the law regarding narrowly defined legal issues. Legal research helps guide our behavior to help us comply with the rules of the game. When you need an answer regarding a specific legal issue, you will contact your attorney, who will research the issue, inform you of the results of that research, and advise you of the decisions you must make with respect to that issue.

The goals of this book are practical. Try to conceptualize your study of the legal environment of business as a map by which you must navigate your business dealings. We want to teach you how to read this map so that you are able to understand the law and how it affects your business and your life. Besides limiting legal liability proactively, an understanding of the law can also help you avoid serious missteps. After all, ignorance of the law is no defense for violating the law.

This chapter provides an overview of the legal system. We begin with a discussion of what the law is, and then we turn our attention to the sources of law, the rule of law, the reasons why rule of law is important to business, and how law affects business disciplines such as management, marketing, finance, and accounting. The chapter concludes with a discussion of the link between rule of law and economic prosperity.

Key Takeaways

Law is a dynamic and ever-changing field that affects everyone, both in their individual capacities as people and in their business interactions. Studying the legal environment of business helps us understand how to reduce liability risks, identify legal problems that require an attorney's assistance, and identify the links between business and the law.

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1.2: Sources of Law

Learning Objectives

- Differentiate between social customs and law.
- Become familiar with primary sources of law in the United States.
- Understand the difference between public law and private law.
- Understand the relationship between state and federal systems of government.

Hyperlink: Supreme Court Friezes

http://www.supremecourt.gov/about/north&southwalls.pdf

Along the north and south walls of the Great Hall at the U.S. Supreme Court, friezes representing the great lawgivers in history are carved in marble. Among them are Hammurabi, Moses, Solomon, Draco, Confucius, Muhammad, Napoleon, and one American. Click the link to find out who he is.

Where does the law come from? How do you know right from wrong? Certainly, your caretakers taught you right from wrong when you were a child. Your teachers, community elders, and other people who were in the position to help shape your ideas about appropriate manners of behavior also influenced your understanding of which behaviors are acceptable and which are not. Additionally, employers often have very firm ideas about how their employees should comport themselves. Those ideas may be conveyed through employers' codes of ethics, employee handbooks, or organizational cultures.

Of course, actions that are considered "wrong" and inappropriate behavior are not violations of the law. They simply may represent social norms. For example, it is generally not acceptable to ask strangers about their income. It is not illegal to do such a thing, but it is considered impolite. Imagine that you are interviewing for a position that you really want. Can you imagine yourself asking your potential employer how much money he or she makes? It would not be illegal for the employer to refuse to hire you based on your lack of social skills. However, it would be illegal for the employer not to hire you based solely on your race.

So what is the difference? One type of "right from wrong" is based on societal norms and cultural expectations. The other type of "right from wrong" is based on a source recognized as a holding legitimate authority to make, and enforce, law within our society. These are two types of rules in our society—social norms and laws.

A Question of Ethics

In January 2010, Haiti, the poorest country in the Western Hemisphere, was struck by a massive earthquake that killed tens of thousands—maybe even hundreds of thousands—of people. Rescue workers rushed to remove survivors from the rubble, but in the days following the earthquake, thousands of people wandered the streets without food or shelter. Some instances of looting and violence occurred as survivors grew desperate for sustenance.

In the meantime, Royal Caribbean operated a cruise line that made a regular stop at Haiti, at a private beach where it had previously spent millions of dollars in improvements to ensure that the vacationers on its cruise ships would enjoy themselves during their overnight stops. Within a week of the disaster, Royal Caribbean was seeking to assure its customers that the stop in Haiti was not unethical. It pointed out that bringing tourist dollars to Haiti was actually an ethical thing to do, despite the thousands of dying and injured just a short distance away.

If you were scheduled to begin a vacation on a Royal Caribbean cruise ship that docked at its private beach during the week following the earthquake, would you go? If you decided to go, how would your friends and family react to your choice? If Royal Caribbean was not legally required to issue refunds for non-refundable tickets, should it be willing to issue refunds anyhow?

Social customs may be violated on pain of embarrassment or ostracism. Someone may choose to ignore social customs, but there are usually negative social or professional consequences to doing so. A person who violates social customs may be said to be a

boor, or people may try to avoid that person because his or her actions and comments make others uncomfortable. However, no legal repercussions follow violating social customs.

Violations of law are different. Violating the law carries penalties, such as liability or loss of liberty, depending on the type of violation. While we may generally decide whether or not to conform to social customs, we are compelled to obey the law under threat of penalty.

Law can generally be classified as public law or private law. Public law applies to everyone. It is law that has been created by some legitimate authority with the power to create law, and it has been "handed down" to the people within its jurisdiction. In the United States, the lawmaking authority itself is also subject to those laws, because no one is "above" the law. If the law is violated, penalties can be levied against the violator. These penalties are also "handed down" from some recognized source of authority, like the judiciary. Of course, people in the United States may participate in many law-creating activities. For instance, they may vote in elections for legislators, who, in turn, create legislation. Likewise, if people have a legal claim, their case may be heard by the judiciary.

It's important to note, however, that not all law is public law. Private law is typically understood to be law that is binding on specific parties. For instance, parties to a contract are involved in a private law agreement. The terms of the contract apply to the parties of the contract but not to anyone else. If the parties have a contract dispute, they will be able to use dispute-resolution methods to resolve it. This is because both parties of the contract recognize the judiciary as a legitimate authority that can resolve the contract dispute. However, regardless of the resolution, the terms of the contract and the remedy for breach will apply only to the parties of the contract and not to everyone else.

Additionally, some law is procedural and some law is substantive. Procedural law describes the legal rules that must be followed. In other words, it details the process or rules that are legally required. For instance, the U.S. government must generally obtain a warrant before searching someone's private home. If the process of obtaining the warrant is ignored or performed illegally, then procedural law has been violated. Substantive law refers to the actual substance of the law or the merits of the claim, case, or action. Substantive law embodies the ideas of legal rights and duties and is captured by our different sources of law, like statutes, the Constitution, or common law.

Sources of Law

In the United States, our laws come primarily from the U.S. Constitution and the state constitutions; from statutory law from Congress, the state legislatures, and local legislative bodies; from common law; and from administrative rules and regulations. Executive orders and treaties are also important sources of law. These are all primary sources of law. As is true in any democracy, U.S. law reflects the will of the people who vote for representatives to make the law. In this way, U.S. law is also a reflection of public policy.

Secondary sources of law include restatements of the law, law review and journal articles, uniform codes, and treatises. These sources are created by legal scholars rather than by a recognized, legitimate law-creating authority. However, these sources are read by and often influence those who are in the position to create law. Members of the judiciary, for example, may consult a restatement of law or law-review articles when making decisions. Likewise, state legislatures often adopt whole or parts of uniform acts, such as the Uniform Commercial Code (UCC). When a body of secondary law is formally adopted by a legitimate lawmaking authority, then it becomes primary law. In this example, adoption of the UCC by a state legislature transforms the UCC from a secondary source of law (a model code) to a primary source of law in that state—namely, a statute.

Hyperlink: The U.S. Constitution

http://www.archives.gov/exhibits/charters/constitution_transcript.html

Read the U.S. Constitution at this link.

The U.S. Constitution created the structure of our federal government. Among other things, it sets forth the three branches—the legislative, executive, and judicial branches.

It provides organizational and procedural requirements, defines the boundaries of each branch's jurisdiction, and creates "checks" on each branch by the other branches. For example, look at "Hyperlink: The U.S. Constitution". As you can see, in Article II,

Section 2 the president is the commander in chief of the several armed forces, but he does not have the power to declare war. That duty falls to Congress.

The first ten amendments to the U.S. Constitution are known as the Bill of Rights. Some of the Founding Fathers did not believe that a Bill of Rights was necessary because the power granted to the federal government created by the U.S. Constitution was expressly limited. Any powers not expressly granted to the federal government by the U.S. Constitution are reserved to the states. This means that if the U.S. Constitution does not state that one of the federal branches of government has jurisdiction over a particular area, then that area falls to the states to regulate.

Despite the limited power granted to the federal government by the U.S. Constitution, as a condition of ratification, many states insisted on a written Bill of Rights that preserved certain individual civil rights and liberties. Today, business entities that are treated as legal persons under the law, such as corporations, enjoy many of these rights and liberties, just as if they were natural human beings.

Each state also has its own constitution, and those constitutions serve essentially the same function for each individual state government as the U.S. Constitution serves for the federal government. Specifically, they establish the limits of government power, create protections for fundamental rights, and establish the organization and duties of the different branches of government at the state level.

This dual system of government present in the United States is called federalism, which is a governance structure whereby the federal government and the state governments coexist through a shared power scheme. State laws may not conflict with federal laws, including the U.S. Constitution. This is because the U.S. Constitution is the supreme law of the land.

Statutory law is law created by a legislative body. Congress is the legislative body at the federal level. The states also have legislative bodies, most of which are bicameral, like our federal system. The state legislatures' names vary by state. For instance, in Indiana, the legislature is known as the General Assembly. In North Dakota, it is the Legislative Assembly. In New York, it is called the Legislature. Nevertheless, their purposes are the same. They are the legislative branches of their respective state governments.

Congress is composed of a Senate, with 100 members, and a House of Representatives, with 435 members. The forefathers who wrote the Constitution deliberated and argued over how to compose the legislature, and the result is a deliberative body that doesn't always respond quickly to the will of the majority. Since population numbers from the census taken every ten years determine how many House seats a state receives, smaller states are sometimes disproportionately represented in the Senate. Alaska and Delaware, for example, have only one representative in the House, but each has two senators. Senators serve six-year terms, and members of the House of Representatives serve two-year terms. There are no term limits for either senators or members of the House. One benefit of having no term limits is that institutional knowledge and wisdom can be carried forward in perpetuity. One drawback is that elected officials may hedge their votes on important issues in a calculated way, to ensure reelection. If term limits were imposed, then vote pandering would not be a problem, but the Congress would be forever laboring with many inexperienced lawmakers.

As you can see from "Hyperlink: How a Bill Becomes a Law", a bill may be introduced in Congress through the Senate or through the House of Representatives. Both the House of Representatives and the Senate have many committees, and these are related to all areas under the purview of Congress to legislate. After a bill is introduced, it is sent to an appropriate committee in the chamber of the Congress where the bill originated. If the committee moves forward with the bill, it modifies the bill as it sees fit to do, and then it sends the bill to the house of origination (either the Senate or the House of Representatives) for a vote. If the bill passes, then it is sent to the other house (again, either the Senate or the House of Representatives), where it undergoes the same process. If the other house votes to approve the bill, then the bill goes to the joint committee, which is composed of members of both the House of Representatives and the Senate, where final work is completed. After that, the bill is sent to Congress for a full vote. If the bill passes, it is sent to the president. If the president signs the bill, then it becomes a statute.

The president may veto a bill. A presidential veto is an executive "check" on the legislative body. However, if the president vetoes a bill, the legislature can override the veto by a supermajority vote. A congressional override is a legislative "check" on the executive branch. These checks are built into our U.S. Constitution.

Hyperlink: How a Bill Becomes a Law

http://www.lexisnexis.com/help/CU/The_Legislative_Process/How_a_Bill_Becomes_Law.htm

Check out the interactive flowchart for how a bill becomes law. Be sure to click on the different boxes for additional information about each step.

Importantly, Congress may not act outside of its enumerated powers. Many people wrongfully believe that Congress can do anything. That is simply not true. Look at Article I, Section 8, accessible through "Hyperlink: The U.S. Constitution", for the enumerated powers of Congress. Remember that any power not granted to the federal government by the U.S. Constitution is reserved to the states. This means that if Congress passed a law in an area that was actually reserved to the states to regulate, Congress would have acted outside the scope of its powers. If challenged, the law would be struck down as unconstitutional.

As a practical matter, this means that many U.S. states have state laws that are very different from each other. For instance, in Oregon, certain terminally ill patients may legally commit suicide under the state's Death with Dignity Act. However, in many other states, such an act would be illegal.

Common law is judge-made law. Common law is a feature of most countries previously colonized by Great Britain, where it originated. In continental Europe, an alternative system called civil law developed, where judges do not have the power to create law through interpretation. In civil-law jurisdictions, only the legislature may create law. A jurisdiction is an area where power may be exercised.

In a common-law system, when an appellate court hears cases and writes opinions, rules of law are created, formed, and shaped. After a particular legal issue has been decided in a jurisdiction, there is a high probability that subsequent cases that present the same legal issue will use the same rule of law generated from already-decided cases regarding the same legal issue. This policy is known as stare decisis, or "let the decision stand." This is how a precedent is formed, though precedents may shift or change over time. Precedents also may be entirely overturned, though that is rare. Precedents and stare decisis allow us to anticipate the behavior of others and to gauge the legality of our own actions.

Legal reasoning is used by attorneys to argue for a particular outcome in a case and by judges when rendering decisions. At its most basic form, legal reasoning involves first identifying the legal question, which is the issue in dispute. Then, the rule of law that applies to that issue is identified. The rule of law may be drawn from precedent, for example. The facts of the case are analyzed against the rule of law to reach a supportable conclusion. This method of legal reasoning is referred to as the IRAC method, which is an acronym for issue, rule, analysis, and conclusion.

Common law is an important source of law in those many areas that are reserved to the states to regulate. A state may exercise its police powers to regulate the safety, health, and welfare of its citizens, for example. The laws implemented in these areas may give rise to laws in divergent areas, such as property law (e.g., zoning regulations), so-called vice laws (e.g., restrictions on vice business activities in certain areas or during certain days), and domestic relations (e.g., laws relating to marriage and adoption). It's also important to note that precedents vary among different jurisdictions because precedents created by one jurisdiction are not binding in other jurisdictions.

Most administrative agencies are created by the legislature. At the federal level, they are created by Congress, and at the state level, they are created through the state legislative bodies. Administrative agencies may be thought of as a delegation of congressional authority to area experts in particular fields, so that those experts can engage in limited lawmaking, adjudicative procedures, and investigations within their particular purviews. Laws made by administrative agencies are called rules or regulations. Administrative agencies are created by enabling legislation, which sets forth the agencies' jurisdictional boundaries, rule-making procedures, and other information relating to agencies' scopes of power.

Key Takeaways

The legal system in the United States is composed of multiple jurisdictions at the local and state levels and one federal jurisdiction. Local and state laws may not conflict with federal laws. Primary sources of law in the United States include constitutional law, statutory law, common law, and administrative law.

Exercise 1.2.1

1. Identify an action that would violate social norms but would not violate any laws. Can you identify any violations of law that would not violate any social norms?
2. What are three specific powers of Congress? What are three specific powers of the executive branch? Do you think that the powers of the judicial branch are well defined? Why or why not?
3. What areas of law have been reserved to the states to regulate? How do you know?
4. Identify a bill in either the House of Representatives or the U.S. Senate. What stage(s) of the bill process has it passed through? To be passed into law, what stages must it still pass through?
5. Which three federal administrative agencies affect you or your family the most? Why?

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1.3: The Rule of Law

Learning Objectives

- Understand what a rule of law system is.
- Explore the U.S. rule of law system.

When you hear the term “rule of law,” what comes to mind? It may seem like an ambiguous term, but it is used frequently in legal and governance circles. Rule of law is a system of laws under which the people and the government are bound, which allows predictability and restraint of government action.

A rule of law legitimizes the law. It establishes clear rules of behavior, establishes (or captures) precedent, and seriously undermines any defense of ignorance of the law. Moreover, it holds people to the same standards, though in many ancient rules of law, the standards differed depending on the person’s classification. For instance, men often had different rights than women. Slaves were a different legal class than those who were free, and indentured servants were often a different classification altogether. When people are held to the same standards, we can see systems of fairness (that is, equal justice under the law) emerging, at least for those within the same class.

The Founding Fathers of the United States did not create our rule of law system out of thin air. Many rule of law systems existed prior to the founding of the United States. The U.S. rule of law system has many similarities with prior rule of law systems from which our Founding Fathers drew their ideas. We can trace elements of our legal genealogy back to ancient Babylon. For example, who has the right to govern, the legitimate sources of law, the organization of government, substantive and procedural legal responsibilities, processes for dispute resolution, and consequences for legal transgressions are all common foci for rule of law systems.

Can you imagine if we had no way to determine these things? Imagine that we did not know who had the legitimate right to govern or that we did not know which sources of law were legitimate. If we did not have a rule of law system that specified and legitimized these and other foundational issues, chaos would rule. There would likely be competing claims of authority between different factions of power if our U.S. Constitution and our state constitutions did not create our systems of government. Likewise, there would be competing sources of law—such as those based on religious texts, or others created by modern human beings—if our constitutions did not legitimize the manner in which laws were to be created. Also, there would be different methods of dispute resolution. Perhaps some people would favor a vigilante system, while others would prefer a procedural system. This type of unpredictability would result in a very unstable society. We should not take the American rule of law system for granted. It provides predictability and stability to our lives.

Rule of law systems establish authority, create expectations for behavior, and establish redress for grievances and penalties for deviance. Governance of conflict and the attainment of peace among the governed are primary goals of rule of law systems. For example, securing peace is a goal within the U.S. rule of law system. The U.S. Constitution’s preamble states, “We the People…in Order to…insure domestic Tranquility.” We see this same notion in the English Bill of Rights of 1689, though th*e words used are somewhat different.*

According to many rule of law systems, the attainment of peace relies on the establishment of a hierarchical authority structure. This recognition of the right to govern provides legitimacy. For instance, in the Code of Hammurabi and the Magna Carta, these rights are derived from religious authority. In the U.S. Constitution and the English Bill of Rights of 1689, the power is derived from the people.

Note the difference between power and authority. Power is the ability to make someone behave in a predictable manner. Authority draws its strength from legitimacy. Imagine that your friend told you that his mother granted him the right to govern others. Would you believe him? Probably not. Why? Because it is unlikely that you would recognize your friend’s mother as having a legitimate authority to bestow the right to govern on anyone, including your friend. Imagine, instead, the governor of your state. You probably recognize the authority of the governor to govern, because you recognize that the people, through representative government, have the authority to elect the governor to do so.

The rule of law of the federal government in the United States is composed of many different sources of law, including constitutional law, statutory law, rules and regulations promulgated by administrative agencies, federal common law, and treaties. Additionally, within the United States, several state and local jurisdictions exist, each having its own rule of law systems. Moreover, the U.S. system of governance is one of federalism, which allows different rule of law systems to operate side by side. In the United States, these systems are the federal government and the state governments.

Organizational structures for government—including who has the right to govern—are also set out in rule of law systems. For instance, the Code of Hammurabi identified a ruler: Hammurabi himself. The English Bill of Rights of 1689 required representative bodies. The U.S. Constitution organized the U.S. government by creating the legislative, executive, and judicial branches. These models minimally provide order and, in some cases, provide opportunities for the governed to participate in government, both of which create role expectations of the governed.

Notably, even though our Founding Fathers relied on prior rule of law systems when creating our Constitution, they were unable to resolve all challenges that exist when people live together. Today, for instance, one unresolved challenge is reflected in the tension between personal liberty and responsibility to state. We have many individual rights and personal liberties, but as some argue, we do not have many responsibilities to the state. We could have a system that requires greater duties—such as the legal duty to vote, to serve in public office or in the military, or to maintain public lands. Unresolved challenges highlight the fact that rule of law systems are not perfect systems of governance. Nevertheless, these systems create expectations for conduct, without which governance of conflict could not reasonably exist and peace could not be attained.

The U.S. Constitution is the foundation on which the U.S. federal rule of law system rests. It asserts the supremacy of law. “We the people” is a very important part of the preamble, because it confers power on the people as well as on the states. Notably, unlike the Magna Carta and the English Bill of Rights of 1689, it does not focus on individual rights. Of course, the Bill of Rights does focus on individual rights, but those amendments were passed after the Constitution was written. (That is why they are called *amendments* to the constitution.) The U.S. Constitution implemented the supremacy of law using structure and processes. The Founding Fathers were particularly concerned about giving the government the power to do its job without encouraging tyranny. They built in processes to ensure the supremacy of law. Indeed, ours is “a government of laws and not of men,” John Adams wrote in the Massachusetts Constitution. Thomas Paine noted the same sentiment in *Common Sense*, when he wrote, “the law is king.”

Key Takeaways

Rule of law is a system of published laws under which the people and the government are bound, which allows predictability and restraint of government action. A rule of law system allows people to understand what is expected of them. It provides a system that allows many people with different beliefs and cultures to live together in peace, by providing methods by which conflicts can be resolved. The U.S. rule of law system contains many elements of prior rule of law systems.

? Exercise 1.3.1

1. View the Code of Hammurabi at http://avalon.law.yale.edu/ancient/hamframe.asp. Scroll down slightly until you see the subheading “Code of Laws.” Find three laws that you believe are similar to laws that we have in the United States.
2. Given the long history of rule of law systems, why hasn’t any rule of law system been developed that resolves all problems? Name three social problems that our rule of law system does not address, or does not address adequately.
3. Are the Ten Commandments a rule of law system? How many of the Ten Commandments are illegal in your state today?
4. What problems would exist without a rule of law?
5. How does the rule of law affect business?

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1.4: Importance of Rule of Law to Business

Learning Objectives

- Determine why the rule of law is important to business.
- Identify several areas of law that are especially relevant to business and the importance of the rule of law to those areas.
- Identify how the rule of law limits government.
- Identify how the rule of law protects people from harmful business practices.

As you may have guessed by now, the rule of law is important to business. Can you imagine trying to do business without being able to have any reasonable expectations of other people's behavior? Would you be willing to conduct business if you had no legal means by which to protect your property interests? And in the case of a dispute, without a rule of law system, there would be no established way of resolving it. Without the rule of law, business would be chaotic. This section provides some overarching examples of why the rule of law is important to business.

Before getting to those examples, imagine this: What if you did not know how to play chess, but you tried to play anyhow? You would probably become frustrated very quickly, because you would see no logic in the movement of your opponent's pieces, and you would not be permitted to move some pieces like you might wish to. Sometimes you would see your opponent move his or her knight two spaces in one direction and then one space in another. Other times, you would see your opponent move his or her bishop diagonally. Moreover, you would not understand what you were and were not permitted to do. You would also not know how to penalize an opponent who moved his or her pieces incorrectly to gain advantage or to take something of yours. This is analogous to what it's like to do business without understanding the rules of the game.

The rule of law establishes rules that people—and businesses—must follow to avoid being penalized. The rule of law not only allows people to understand what is expected of them in their personal capacities but also sets forth rules for businesses so that they, too, know what is expected of them in their dealings and transactions. In addition, it restrains government and others from infringing on property rights. Should disputes arise, the rule of law provides a peaceful and predictable means by which those disputes can be resolved.

The rule of law provides guidance and direction in every area of business. For example, it provides a means to bring a complaint against another party to a neutral decision-maker so that a decision can be made regarding the dispute. Because of our rule of law system, we know that we are permitted to file a complaint in the proper court to commence litigation. Or we can try an alternative method of dispute resolution if we do not wish to engage in litigation. We know that we are permitted to do these things because our rule of law system allows us to do them. Moreover, we can expect some sort of resolution when we institute such a proceeding. This expectation is reasonable only because we have a rule of law.

Additionally, in the United States, the rule of law provides a sophisticated system of federalism, where state and federal laws coexist. This allows people and businesses to determine which system of government pertains to them and which jurisdiction they belong to. Imagine that you sell firearms in a retail capacity. You would be subject to both state and federal laws. You would be required to carry a federal permit from the federal administrative agency known as the Bureau of Alcohol, Tobacco, Firearms, and Explosives. You would be forbidden from engaging in illegal arms trading. According to state laws, you would likely have to ensure that each purchaser of a firearm held a valid permit for a firearm. You would be required to check identification, enforce waiting periods, and refuse to sell guns to people who were not permitted to carry them according to your state's laws. If we did not have a rule of law system, you might be uncertain how to conduct your business, and you would be subject to arbitrary enforcement of unstated or ex post facto (retroactive) laws that affected your business.

The rule of law also governs contracts between people and between merchants. Under the common law system, certain elements of a contract must exist for the contract to be enforceable. Under the Uniform Commercial Code (UCC), merchants are governed by a separate set of rules that anticipate and allow for flexibility in contractual terms, to facilitate business needs. In the event that terms conflict in an offer and acceptance between merchants, the UCC allows "gap fillers" to complete the terms of the contract without need for the contract to be rewritten or for formal dispute resolution. Moreover, businesses rely on the rule of law to help them enforce contracts against contractors who fail to perform.

Additionally, because we have a rule of law system, employers know the rules of the game regarding their relationship to employees, and employees know the rules with respect to their obligations to employers. Likewise, business partners, members of boards of corporations, and members of limited liability companies all know what is expected of them in their roles vis-à-vis the business and other people within their organizations. When someone does something that is not permitted, there is legal recourse.

The rule of law also provides protection for property. Imagine if we did not have protection for nontangible property, such as intellectual property like trade secrets, trademarks, or copyrights. It would be very difficult to protect this type of property if we did not know the rules of the game. People would not have the incentive to create or share new intellectual property if they had no reasonable expectation of being able to protect it or of being rewarded for their creations. Likewise, the rule of law allows us to protect tangible property without having to go to extraordinary measures. For instance, if we had no rule of law system to convey and maintain legal ownership to us for our real or personal property, we might be forced to hire expensive private security forces to guard our property when we could not be there to physically protect it ourselves.

Businesses also rely on the rule of law to govern their debtor and creditor relationships. And, if financial matters do not go as anticipated, our legal system allows businesses to ask the court for protection from creditors under our bankruptcy law. This allows businesses to protect their property from creditor repossessions or foreclosures while they get back on track financially.

The rule of law also protects people from businesses. For example, Congress has enacted antitrust legislation that prevents certain anticompetitive practices, such as colluding and price-fixing. Additionally, businesses are prohibited from using deceptive advertising and are held responsible when they manufacture or sell defective products that cause injury.

The rule of law also protects businesses from government. Since everyone is subject to the rule of law, this means that government itself may not overextend its reach when regulating or investigating businesses. Government must play by the rules, too. For example, imagine that our government could do anything, without any limits or jurisdictional restraints. A business operating in such a climate might find itself subject to government closure on a whim, or excessive taxes, or requirements to pay bribes to gain permits to do business. Our rule of law system prevents such abuses.

Without a rule of law system, people would have to exact satisfaction for the wrongs committed against them on their own. They would have to physically protect their own property. This would lead to a breakdown in social structure, and it would result in vigilante justice and physical strength playing primary roles in dispute resolution.

Key Takeaways

The rule of law system in the United States sets the rules of the game for doing business. It creates a stable environment where plans can be made, property can be protected, expectations can exist, complaints can be made, and rights can be protected. Violation of the law can result in penalties. The rule of law protects business, protects consumers from harmful business practices, and limits government from engaging in abusive practices against businesses.

? Exercise 1.4.1

1. Have you ever played a game in which you did not know all the rules? Have you ever tried to speak a language in which you weren't fluent? What was the outcome?
2. What incentive or motivation would exist to work for your employer if you were not certain that you would be paid for your efforts and your time? What incentive would you have to invent something new, create a work of art, or write a book if you had no legal expectation that you would be able to protect your creation?
3. Imagine that you are an entrepreneur. What type of business would you open? Would you know what types of permits were required to conduct your business and which government entities had jurisdiction over your business? If not, how could you find out?
4. What would business be like in a land without any rule of law system? Be specific.

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1.5: How Law Affects Business Disciplines

Learning Objectives

- Identify the relevance of law to business disciplines.
- Understand the relevance of law to the study of business.
- Identify how the rule of law protects people from harmful business practices.

Foundational courses taken by undergraduate business students usually include accounting, finance, management, and marketing. An understanding of the legal environment of business is relevant—indeed, essential—to functioning well within each of those disciplines. Additionally, a solid understanding of the legal environment can help avoid liability or at least minimize risk. In business, it is not enough to comport yourself and your business ethically. You must also ensure that you understand the legal environment in which you are working. Therefore, it is important to you, to your employer, and to all the other people who may be relying on your business expertise—such as your employees and your family—to understand the legal environment. Such an understanding will help you avoid or lessen the likelihood of liability exposure, enabling you to manage your business affairs successfully, unhampered by unmanaged legal liability risks. This section provides some examples of how law affects specific business disciplines.

During the last several years, accountants have been in the limelight due to culpable behavior of some members of the profession during well-known business scandals, such as Enron. Largely as a result of the fallout from the Enron case, Congress passed the Sarbanes-Oxley Act (SOX) of 2002, which imposed stringent oversight requirements on accounting and auditing firms. The requirements seek to ensure competence, compliance with security laws, and conduct consistent with generally accepted accounting principles.

Of course, the Enron scandal and SOX were both fairly dramatic examples of how law can affect accounting. Other ways in which law affects this discipline are through regulation. For example, the U.S. Securities and Exchange Commission's (SEC) mission is to protect investors and to maintain a fair market, among other things. Accordingly, the SEC enforces accounting and auditing policies to allow investors to make decisions based on accurate information. The SEC pursues charges of accounting fraud and oversees private regulation of the accounting profession.

The law also affects finance. Like accounting professionals, many who work in finance are also regulated by the SEC. The SEC is concerned that investors receive accurate information to make investment decisions. Moreover, the SEC enforces prohibitions against insider trading and pursues claims of other types of securities fraud, such as Ponzi schemes.

Similarly, several statutes protect consumers in financial transactions. For example, the Truth in Lending Act (TILA) requires lenders to accurately provide information concerning the costs involved in offers of credit. TILA and its corresponding Regulation Z are administered by federal banking agencies.

Law also affects those in management. For instance, knowledge of employment law is essential to those in human resources. Title VII of the Civil Rights Act prohibits discrimination related to protected characteristics in hiring and employment practices. Those in management also must be aware of the potential liability that demands on employees might create. For example, in Oregon, McDonald's was found to be liable for injuries resulting when an off-duty, off-premises worker fell asleep while driving.*Faverty v. McDonald's*, 892 P.2d 703 (Or. Ct. App. 1995). The employee had worked three shifts during a twenty-four-hour period. The court held that employers have a duty to avoid conduct that creates a foreseeable risk of harm to others.

If your field is marketing, the law also relates to your work. Marketers must be particularly attuned to tort law, consumer protection law, and intellectual property law. For example, to avoid charges of libel, those in advertising need to take care not to defame another person, business, or product. It might be tempting to do so, especially if you were engaged in serious competition with another company that sold a similar product. Likewise, marketers must take great care not to engage in deceptive advertising practices, lest their employer run afoul of the Federal Trade Commission's (FTC) policies or the FTC Act. Additionally, marketers must be aware of other people's intellectual property to avoid copyright or trademark infringement in their own work product.

These are a few examples of how the law relates to specific business disciplines. Of course, this is just an overview. It is incumbent on each business professional to become familiar with the legal environment in his or her profession. Employers may provide

training regarding legal environment issues, such as anti-sexual harassment training or anti–insider trading training, but ultimately, becoming familiar with the legal environment is each person's individual responsibility. Remember that a defense of "I didn't know the law!" is no defense at all.

Key Takeaways

The law is relevant to every business discipline. Minimizing liability exposure is a primary concern of business, and an understanding of the legal environment relevant to each disciplinary perspective helps business practitioners minimize their risk of incurring liability to themselves or to their employers.

Exercise 1.5.1

1. Which business discipline is your favorite? Find a newspaper article that illustrates a legal problem pertaining to that discipline that could have been avoided with a better understanding of the legal environment of business.
2. How can employers use knowledge of the legal environment of business to minimize liability exposure? Identify three concrete ideas.
3. How can employers stay current with the legal environment of business? For example, how would other employers in Oregon find out about the case of the off-duty, off-premises worker mentioned in this section? If you were an employer in Oregon, how might this case change your business practices?
4. Do you think that if employers train their employees how to behave on the job, those employers should be absolved from legal liability resulting from employees' actions? For example, imagine that an employer provides training to its employees regarding how to avoid sexual harassment in the workplace, but an employee ignores the training and sexually harasses a colleague. Should the employer bear liability in that situation? Why or why not?

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1.6: Concluding Thoughts

This chapter provides an introduction to the legal environment of business. Knowledge of the legal environment of business is essential to successful business practices. This involves understanding what the law is, where it comes from, and specifically how it relates to business. Moreover, different philosophies of law exist. Approaching a problem from different perspectives allows for multiple outcomes to be explored. Additionally, when people approach the same problem from different legal philosophies, reasonable minds can disagree on the outcome. Familiarity with government structure and an understanding of rule of law are essential to successful business operations. Ultimately, businesspeople should be able to recognize legal situations, minimize liability exposure, and know when to consult an attorney.

As you embark on your study of the legal environment, try to remain oriented. Ask yourself questions like “Where does this piece of law fit in the business world?” and “Why is it important for me to know this?” Studying the law can, at times, seem like studying pieces of a very large jigsaw puzzle. You may not immediately see how individual pieces fit together, but with protracted study of law, it will become clear. Often, with that understanding, the depth of law becomes apparent.

Additionally, it is very helpful if you try to find contemporary examples of the concepts that are discussed in this book. When surfing the Internet, watching movies, or reviewing current events, try to “issue spot.” In other words, try to identify the legal issue raised by the particular problem presented. Try to figure out which jurisdiction would have authority over the issue. State government? Federal government? Both? Try to determine which type of law would control or be determinative of the outcome. Is it a statutory issue? A constitutional issue? A regulatory issue?

Also, try to ask yourself why the dispute was raised. Will the parties involved be able to work it out on their own? If not, why not? Has the issue entered into litigation? How could the issue have been avoided with better planning and greater familiarity with the legal environment?

This little game can give you practice in orienting yourself as you gain footing in the study of law and the legal environment of business. We wish you every success in your course!

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1.7: What is Law?

Learning Objectives

- Understand the meaning of jurisprudence and how its study can lead to greater understanding of our laws and legal system.
- Distinguish among law as power, legal positivism, legal realism, and natural law.
- Examine strengths and criticisms of several theories of jurisprudence.
- Explore examples of several theories of jurisprudence.

If you were asked to define "the law," what would you say? Is "you should eat five fruits and vegetables a day" a law? What distinguishes law from mere suggestions or good advice? The key difference is obviously enforcement and consequence. If you don't eat five fruits and vegetables a day, you are not going to be imprisoned or fined. If you steal or embezzle, however, you may be prosecuted and face stiff financial penalties and imprisonment. *Law*, therefore, is a set of rules that are enforced by a government authority.

Now consider the nature of law. Would you say that the law includes only the actual words that are written, or does it also include reading between the lines to discern the spirit of the law? Would you follow a law that you disagreed with, or would you ignore such a law? Do you believe that what the law actually *is* matters as much as who enforces it? Do you think that morality is a part of legality, or do you think that morality is wholly separate from the law?

Based on the particular system of jurisprudence to which one ascribes, these questions will generate different answers. Not only will the answers to these questions differ, but the potential outcomes of legal disputes can also vary widely, depending on one's conception of what the law is. These differences highlight fundamental disagreements over the *nature* of law.

Jurisprudence is the philosophy of law. The nature of law has been debated for centuries, giving rise to a general coalescence of ideas to create particular schools of thought. Several different theories of jurisprudence are explored in the paragraphs that follow.

At a most basic interpretation, some believe that law is simply power. That is, the law is followed because the sovereign issues orders that are backed by threats. Consider tyrannical rulers who create arbitrary laws or bad laws. If the sovereign has the power to enforce those "laws," then regardless of the "badness" of the law, it is still law. The Nazis executed six million Jews pursuant to German law during World War II. Saddam Hussein routinely tortured and executed political opponents and minority Sunni Muslims in Iraq under Iraqi law. The military in Myanmar (known euphemistically as the State Peace and Development Council) imprisoned the democratically elected and Nobel Peace Prize–winning prime minister of the country, Aung San Suu Kyi (Figure 1.2.1 "Aung San Suu Kyi"), under color of authority. (Actions taken under the law are said to be under the color of authority.) Those who ascribe to the idea that law is power often argue that coercion is an essential and necessary feature of law.



Figure 1.7.1: Aung San Suu Kyi. Source: Photo courtesy of the U.S. Department of State, en.Wikipedia.org/wiki/File:Burma_3_150.jpg.

Let's explore whether the law is nothing more than power. If an armed person robs your store, you will very likely hand over whatever it is that he or she wants. The robber has exercised power over you but has not exercised the law. This is because, as you might point out, an armed robber is not the sovereign power. But compare this to a sovereign who exercises power over you. For instance, imagine a government that institutes compulsory military service (the draft) under threat of imprisonment for failing to comply. The sovereign would have the power to deprive us of our liberty if we did not follow the rules; such a law certainly has the force of power behind it.

Many have criticized the understanding of law as nothing more than power backed by threats. For example, some point out that if law is nothing more than power, then the subjects of the law are simply at the mercy of whoever is in power. If we look at the U.S. system of government, however, citizens generally do not feel that they are "at the mercy" of the government. This is because people also have power. People can elect their government officials, and they can vote "out" government officials who aren't doing a good job. In this way, those in power are accountable to the people. Other criticisms include the more piercing observation that not all law requires the exercise or threat of overt power. For instance, many of our laws rely on economic incentives, rather than force of power, to encourage compliance. Though penalty provisions may exist for violating those laws, those penalties may not be driving compliance itself.

A competing view is that of legal positivism, whose proponents disagree that law is simply power. Legal positivists believe that the law is what the law says. The laws are written, human-made rules. The law is not drawn from any source higher than man. Legal positivists do not try to read between the lines. They may disagree with the law as it is written, but they will acquiesce to the sovereign power and follow the law as it is written. They reject any belief that they have an individual right to disobey a law that they happen to oppose, providing that the law is from a legitimate source. Positivists believe that law is wholly separate from any consideration of ethics. Moreover, they do not believe that people have intrinsic human rights other than those created by the law. This is very different from a natural rights perspective, which is discussed in the following paragraphs.

Positivists differ from the view that law is simply power, because they believe that valid law must be created pursuant to the existing rules that allow the sovereign to create law. Under this way of thinking, an arbitrary declaration of law by a sovereign who did not follow the rules for creating the law would not be viewed as valid law. Additionally, positivists would not consider any rule or "law" created by an illegitimate ruler as valid law. Consequently, a legal positivist would feel no need to obey an illegitimately created "law."

Consider the example of the draft again. Some people have a strong moral objection to engaging in armed conflict with other human beings. However, a legal positivist would most certainly comply with a law that required compulsory conscription, though he or she might use other legal channels to try to change the law.

A common criticism of legal positivism is that it prohibits individuals from remaining true to their own consciences when their consciences conflict with the laws of the sovereign. However, for a positivist, the desirability of enacting a law that might be viewed as "good" or "bad" is not relevant for determining what the law is.

Some critics point out that legal positivism is too limited in its conception of law. For instance, at least some laws seem to reflect a moral stance. The prohibition against insider trading (using nonpublic information to buy or sell a stock to make money) might be said to encompass the idea of fairness, which is a moral consideration. Likewise, due process (fundamental fairness and decency in government actions) might be said to encompass the ideas of both fairness and a moral position against cruelty. Moreover, not all law is the result of a sovereign-issued, written rule. For example, international customary law has developed through customary practices. It is valid law, but it is not a set of rules handed down from a sovereign ruler.

A different viewpoint is legal realism, which is the belief that the law itself is far less important than the consideration of who is in the position to enforce the law. Like positivists, legal realists believe that law is the product of human making. However, unlike positivists, they believe that the outcome of any issue that arises under law is dependent on the person, such as a judge, who is in the position to exercise power under the mantle of the law. Additionally, realists believe that social and economic considerations should be brought to bear in legal disputes, which may very well be "extra" considerations that are not captured by the written law itself.

If a realist brought a dispute before a particular judge who was known to be unsympathetic to that particular type of dispute, the realist would believe that the judge's decision would reflect that leaning. For example, if a dispute arose under the Clean Water Act, and the defendant was a legal realist who believed that the judge was unduly harsh with environmental offenders, the legal realist would not look to the actual words of the Clean Water Act itself to determine a likely outcome. Instead, the defendant would view the judge's personal and professional beliefs about water pollution as determinative factors. Moreover, if the plaintiff in the same case were a realist who did not believe that the Clean Water Act was very strong, that plaintiff might hope that the judge would consider the social importance of clean water to human health, natural environment, and nonhuman animals.

Critics of legal realism point out that those who are in the position to exercise the power of the law over others should not circumscribe the checks and balances of our system of government by considering factors outside of legitimate sources of law

when making decisions. For instance, they argue that judges should not use any factors other than the written law when rendering decisions. Legal realists, however, point out that judicial interpretation not only is necessary but also was contemplated by our Founding Fathers as a built-in check and balance to our other branches of government.

Natural law is the idea that humans possess certain inalienable rights that are not the products of human-made law. Therefore, we can say that natural law differs from both positivism and realism in this important respect. Humans are able to reason, and therefore they are able to discover moral truths on their own. They are not automatons who require a sovereign power to tell them right from wrong. Natural law adherents do not reject human-made law. However, they recognize that human-made law is subordinate to natural law if the two types of law conflict.

Civil rights activists often rely on natural law arguments to advance their platforms. This is true today as well as historically. For example, a civil rights advocate might point out that regardless of what the law "says," discrimination based on race is simply wrong. If the written law allowed racial discrimination, natural law adherents would not recognize the law as valid.

Each theory of jurisprudence can inform our understanding of legal issues by allowing us to see the same thing from many different perspectives. Moreover, depending on philosophical perspective, there may be several possible outcomes to the same legal dispute that are equally supportable. This understanding can help us identify common ground among disputants as well as points of departure in their reasoning.

Key Takeaways

Different theories of jurisprudence inform our understanding of what the law is. Examining legal issues through the lenses of different theories of jurisprudence allows us to see how different outcomes can be defended.

? Exercise 1.7.1

1. Read "The Case of the Speluncean Explorers" at www.nullapoena.de/stud/explorers.html. Identity the justice's opinion with which you most closely agree. Name the different theories of jurisprudence used by each justice in reaching his or her opinion.
2. What are some examples of natural law in our legal system or system of governance?
3. Is it more important for you to follow the letter of the law or to follow the spirit of the law? In what circumstance would you believe the opposite to be true?
4. Can you think of any examples of law in which the threat of force or power is not needed?
5. Do you believe that morals are a part of our law, or do you believe that morality and law are separate concepts?

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CHAPTER OVERVIEW

2: Constitutional Law and US Commerce

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2.1: Introduction- Constitutional Law and US Commerce

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2.2: 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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2.3: 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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2.4: 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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2.5: 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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2.6: 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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2.7: 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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2.8: 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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CHAPTER OVERVIEW

3: Corporate Social Responsibility and Business Ethics

3.1: Introduction- Corporate Social Responsibility and Business Ethics

3.2: What Is Ethics?

3.3: Major Ethical Perspectives

3.4: An Ethical Decision Model

3.5: Corporations and Corporate Governance

3.6: Summary and Exercises

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3.1: Introduction- Corporate Social Responsibility and Business Ethics

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3.2: What Is Ethics?

Learning Objectives

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

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

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

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

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

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

There are three key points here:

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

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

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

How Do Law and Ethics Differ?

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

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

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

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

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

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

Why Should an Individual or a Business Entity Be Ethical?

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

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

The market does respond to unethical behavior. In Section 2.4, you will read about the Sears Auto Centers case. The loss of goodwill toward Sears Auto Centers was real, even though the total amount of money lost cannot be clearly accounted for. Years later, there are people who will not go near a Sears Auto Center; the customers who lost trust in the company will never return, and many of their children may avoid Sears Auto Centers as well.

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

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

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

Key Takeaway

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

Exercises

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

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3.3: Major Ethical Perspectives

Learning Objectives

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

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

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

Utilitarianism

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

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

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

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

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

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

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

2. Assuming that the greatest good for you or your company is in fact the greatest good for all—that is, looking at situations subjectively or with your own interests primarily in mind.
3. Underestimating the costs of a certain decision to you or your company. The now-classic Ford Pinto case demonstrates how Ford Motor Company executives drastically underestimated the legal costs of not correcting a feature on their Pinto models that they knew could cause death or injury. General Motors was often taken to task by juries that came to understand that the company would not recall or repair known and dangerous defects because it seemed more profitable not to. In 2010, Toyota learned the same lesson.
4. Underestimating the cost or harm of a certain decision to someone else or some other group of people.
5. Favoring short-term benefits, even though the long-term costs are greater.
6. Assuming that all values can be reduced to money. In comparing the risks to human health or safety against, say, the risks of job or profit losses, cost-benefit analyses will often try to compare apples to oranges and put arbitrary numerical values on human health and safety.

Rules and Duty: Deontology

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

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

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

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

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

Social Justice Theory and Social Contract Theory

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

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

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

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

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

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

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

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

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

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

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

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

Aristotle and Virtue Theory

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

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

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

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

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

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

Josephson's Core Values Analysis and Decision Process

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

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

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

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

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

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

Key Takeaway

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

Exercises

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

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

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

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

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

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3.4: An Ethical Decision Model

Learning Objectives

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

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

Josephson's Core Values Model

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

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

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

The Core Values

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

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

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

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

Key Takeaway

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

Exercises

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

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3.5: Corporations and Corporate Governance

Learning Objectives

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

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

Legal Organization of the Corporation

Figure 3.5.1, though somewhat oversimplified, shows the basic legal structure of a corporation under Delaware law and the laws of most other states in the United States. Shareholders elect directors, who then hire officers to manage the company. From this structure, some very basic realities follow. Because the directors of a corporation do not meet that often, it's possible for the officers hired (top management, or the "C-suite") to be selective of what the board knows about, and directors are not always ready and able to provide the oversight that the shareholders would like. Nor does the law require officers to be shareholders, so that officers' motivations may not align with the best interests of the company. This is the "agency problem" often discussed in corporate governance: how to get officers and other top management to align their own interests with those of the shareholders.

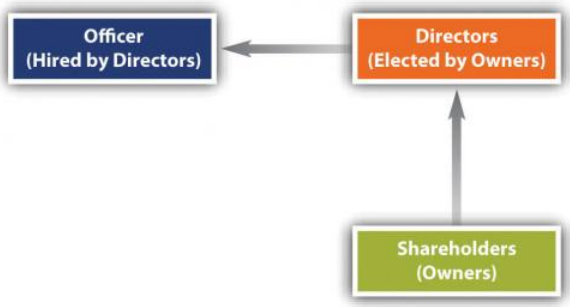


Figure 3.5.1: Corporate Legal Structure

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

Shareholders and Stakeholders

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

Maximizing Profits: Milton Friedman

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

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

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

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

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

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

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

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

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

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

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

Stakeholder Theory

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

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

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

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

According to stakeholder theorists, corporations (and other business organizations) must pay attention not only to the bottom line but also to their overall effect on the community. Public perception of a company's unfairness, uncaring, disrespect, or lack of trustworthiness often leads to long-term failure, whatever the short-term successes or profits may be. A socially responsible corporation is likely to consider the impact of its decisions on a wide range of stakeholders, not just shareholders. As Table 3.5.1 indicates, stakeholders have very different kinds of interests ("stakes") in the actions of a corporation.

Table 3.5.1: The Stakes of Various Stakeholders

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

Corporate Culture and Codes of Ethics

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

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

Ethical Leadership Is Top-Down

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

Accountability Is Often Weak

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

Killing the Messenger

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

Ethics Codes

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

It’s often noted that a code of ethics is only as important as top management is willing to make it. If the code is just a document that goes into a drawer or onto a shelf, it will not effectively encourage good conduct within the corporation. The same is true of any kind of training that the company undertakes, whether it be in racial sensitivity or sexual harassment. If the message is not continuously reinforced, or (worse yet) if the message is undermined by management’s actions, the real message to employees is that violations of the ethics code will not be taken seriously, or that efforts to stop racial discrimination or sexual harassment are merely token efforts, and that the important things are profits and performance. The ethics code at Enron seems to have been one of those “3-P” codes that wind up sitting on shelves—“Print, Post, and Pray.” Worse, the Enron board twice suspended the code in 1999 to allow outside partnerships to be led by a top Enron executive who stood to gain financially from them.FindLaw, *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.*, February 1, 2002, accessed April 5, 2011, http://news.findlaw.com/wsj/docs/enron/sicreport.

Ethics Hotlines and Federal Sentencing Guidelines

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

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

Managing by the Numbers

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

Managing by Numbers: The Sears Auto Center Story

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

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

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

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

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

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

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

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

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

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

Conscious Capitalism

One effort to integrate the two viewpoints of stakeholder theory and shareholder primacy is the conscious capitalism movement. Companies that practice conscious capitalism embrace the idea that profit and prosperity can and must go hand in hand with social justice and environmental stewardship. They operate with a holistic or systems view. This means that they understand that all stakeholders are connected and interdependent. They reject false trade-offs between stakeholder interests and strive for creative ways to achieve win-win-win outcomes for all.Milton Friedman, John Mackey, and T. J. Rodgers, "Rethinking the Social Responsibility of Business," Reason.com, October 2005, http://reason.com/archives/2005/10/01/rethinking-the-social-responsi.

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

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

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3.6: Summary and Exercises

Summary

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

Exercises

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

SELF CHECK QUESTIONS

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

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

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

AnswerS

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

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CHAPTER OVERVIEW

4: Employment Law

4.1: Introduction- Employment Law
4.2: Federal Employment Discrimination Laws
4.3: Employment at Will
4.4: Other Employment-Related Laws
4.5: Cases
4.6: Summary and Exercises

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4.1: Introduction- Employment Law

Because most employees do not belong to unions, a host of laws dealing with the many faces of discrimination shapes employers' power over and duties to their employees. Beyond the issue of discrimination, the law also governs a number of other issues, such as the extent to which an employer may terminate the relationship itself. We examine these issues later in this chapter.

Even before statutes governing collective bargaining and various state and federal discrimination laws, the common law set the boundaries for employer-employee relationships. The basic rule that evolved prior to the twentieth century was "employment at will." We will look at employment at will toward the end of this chapter. But as we go through the key statutes on employment law and employment discrimination, bear in mind that these statutes stand as an important set of exceptions to the basic common-law rule of employment at will. That rule holds that in the absence of a contractual agreement otherwise, an employee is free to leave employment at any time and for any reason; similarly, an employer is free to fire employees at any time and for any reason.

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4.2: Federal Employment Discrimination Laws

Learning Objectives

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

- Know the various federal discrimination laws and how they are applied in various cases.
- Distinguish between disparate impact and disparate treatment cases.
- Understand the concept of affirmative action and its limits in employment law.

As we look at federal employment discrimination laws, bear in mind that most states also have laws that prohibit various kinds of discriminatory practices in employment. Until the 1960s, Congress had intruded but little in the affairs of employers except in union relationships. A company could refuse to hire members of racial minorities, exclude women from promotions, or pay men more than women for the same work. But with the rise of the civil rights movement in the early 1960s, Congress (and many states) began to legislate away the employer's frequently exercised power to discriminate. The most important statutes are Title VII of the Civil Rights Act of 1964, the Equal Pay Act of 1963, the Age Discrimination in Employment Act of 1967, and the Americans with Disabilities Act of 1990.

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_basics_histmats_civilrights64text.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 16.1 A Checklist of Employment Law

Discrimination Based on Religion

An employer who systematically refuses to hire Catholics, Jews, Buddhists, or members of any other religious group engages in unlawful disparate treatment under Title VII. But refusal to deal with someone because of his or her religion is not the only type of

violation under the law. Title VII defines religion as including religious observances and practices as well as belief and requires the employer to "reasonably accommodate to an employee's or prospective employee's religious observance or practice" unless the employer can demonstrate that a reasonable accommodation would work an "undue hardship on the conduct of the employer's business." Thus a company that refused even to consider permitting a devout Sikh to wear his religiously prescribed turban on the job would violate Title VII.

But the company need not make an accommodation that would impose more than a minimal cost. For example, an employee in an airline maintenance department, open twenty-four hours a day, wished to avoid working on his Sabbath. The employee belonged to a union, and under the collective bargaining agreement, a rotation system determined by seniority would have put the worker into a work shift that fell on his Sabbath. The Supreme Court held that the employer was not required to pay premium wages to someone whom the seniority system would not require to work on that day and could discharge the employee if he refused the assignment.*Trans World Airlines v. Hardison*, 432 U.S. 63 (1977).

Title VII permits religious organizations to give preference in employment to individuals of the same religion. Obviously, a synagogue looking for a spiritual leader would hire a rabbi and not a priest.

Sex Discrimination

A refusal to hire or promote a woman simply because she is female is a clear violation of Title VII. Under the Pregnancy Act of 1978, Congress declared that discrimination because of pregnancy is a form of sex discrimination. Equal pay for equal or comparable work has also been an issue in sex (or gender) discrimination. *Barbano v. Madison County* (see Section 16.4.1 "Disparate Treatment: Burdens of Proof"), presents a straightforward case of sex discrimination. In that case, notice how the plaintiff has the initial burden of proving discriminatory intent and how the burden then shifts to the defendant to show a plausible, nondiscriminatory reason for its hiring decision.

The late 1970s brought another problem of sex discrimination to the fore: sexual harassment. There is much fear and ignorance about sexual harassment among both employers and employees. Many men think they cannot compliment a woman on her appearance without risking at least a warning by the human resources department. Many employers have spent significant time and money trying to train employees about sexual harassment, so as to avoid lawsuits. Put simply, sexual harassment involves unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature.

There are two major categories of sexual harassment: (1) quid pro quo and (2) hostile work environment.

Quid pro quo comes from the Latin phrase "one thing in return for another." If any part of a job is made conditional on sexual activity, there is quid pro quo sexual harassment. Here, one person's power over another is essential; a coworker, for example, is not usually in a position to make sexual demands on someone at his same level, unless he has special influence with a supervisor who has power to hire, fire, promote, or change work assignments. A supervisor, on the other hand, typically has those powers or the power to influence those kinds of changes. For example, when the male foreman says to the female line worker, "I can get you off of the night shift if you'll sleep with me," there is quid pro quo sexual harassment.

In *Harris v. Forklift Systems, Inc*.*Harris v. Forklift Systems, Inc.*, 510 U.S. 17 (1993). and in *Meritor v. Vinson*,*Meritor v. Vinson*, 477 U.S. 57 (1986). we see examples of hostile work environment. Hostile work environment claims are more frequent than quid pro quo claims and so are more worrisome to management. An employee has a valid claim of sexual harassment if sexual talk, imagery, or behavior becomes so pervasive that it interferes with the employee's ability to work to her best capacity. On occasion, courts have found that offensive jokes, if sufficiently frequent and pervasive in the workplace, can create a hostile work environment. Likewise, comments about body parts or public displays of pornographic pictures can also create a hostile work environment. In short, the plaintiff can be detrimentally offended and hindered in the workplace even if there are no measurable psychological injuries.

In the landmark hostile work environment case of *Meritor v. Vinson*, the Supreme Court held that Title VII's ban on sexual harassment encompasses more than the trading of sexual favors for employment benefits. Unlawful sexual harassment also includes the creation of a hostile or offensive working environment, subjecting both the offending employee and the company to damage suits even if the victim was in no danger of being fired or of losing a promotion or raise.

In recalling *Harris v. Forklift Systems* (Chapter 1, Section 1.6), we see that the "reasonable person" standard is declared by the court as follows: "So long as the environment would reasonably be perceived, and is perceived, as hostile or abusive there is no

need for it also to be psychologically injurious." In *Duncan v. General Motors Corporation* (see Section 16.4.2 "Title VII and Hostile Work Environment"), *Harris* is used as a precedent to deny relief to a woman who was sexually harassed, because the court believed the conditions were not severe or pervasive enough to unreasonably interfere with her work.

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 RatonFaragher v. City of Boca Raton*, 524 U.S. 775 (1998). and in *Burlington Industries, Inc. v. Ellerth*,*Burlington Industries v. Ellerth*, 524 U.S. 742 (1988). female employees sued for sexual harassment. In each case, they proved that their supervisors had engaged in unconsented-to touching as well as verbal sexual harassment. In both cases, the plaintiff quit her job and, after going through the EEOC process, got a right-to-sue letter and in fact sued for sexual harassment. In *Faragher*, the employer had never disseminated the policy against sexual harassment to its employees. But in the second case, *Burlington Industries*, the employer had a policy that was made known to employees. Moreover, a complaints system had been established that was not used by the female employee.

Both opinions rejected the notion of strict or automatic liability for employers when agents (employees) engage in sexual harassment. But the employer can have a valid defense to liability if it can prove (1) that it exercised reasonable care to prevent and correct any sexual harassment behaviors and (2) that the plaintiff employee unreasonably failed to take advantage of any preventive or corrective opportunities provided by the employer or to otherwise avoid harm. As with all affirmative defenses, the employer has the burden of proving this defense.

Affirmative Action

Affirmative action is mentioned in the statutory language of Title VII, as courts have the power to order affirmative action as a remedy for the effects of past discriminatory actions. In addition to court-ordered affirmative action, employers may voluntarily use an affirmative action plan to remedy the effects of past practices or to achieve diversity within the workforce to reflect the diversity in their community. In *Johnson v. Santa Clara County Transportation Agency*,*Johnson v. Santa Clara County Transportation Agency*, 480 U.S. 616 (1987). the agency had an affirmative action plan. A woman was promoted from within to the position of dispatcher, even though a male candidate had a slightly higher score on a test that was designed to measure aptitude for the job. The man brought a lawsuit alleging sex discrimination. The Court found that voluntary affirmative action was not reverse discrimination in this case, but employers should be careful in hiring and firing and layoff decisions versus promotion decisions. It is in the area of promotions that affirmative action is more likely to be upheld.

In government contracts, President Lyndon Johnson's Executive Order 11246 prohibits private discrimination by federal contractors. This is important, because one-third of all US workers are employed by companies that do business with the federal government. Because of this executive order, many companies that do business with the government have adopted voluntary affirmative action programs. In 1995, the Supreme Court limited the extent to which the government could require contractors to establish affirmative action programs. The Court said that such programs are permissible only if they serve a "compelling national interest" and are "narrowly tailored" so that they minimize the harm to white males. To make a requirement for contractors, the government must show that the programs are needed to remedy past discrimination, that the programs have time limits, and that nondiscriminatory alternatives are not available.*Adarand Constructors, Inc. v. Pena*, 515 U.S. 200 (1995).

The Age Discrimination in Employment Act

The Age Discrimination in Employment Act (ADEA) of 1967 (amended in 1978 and again in 1986) prohibits discrimination based on age, and recourse to this law has been growing at a faster rate than any other federal antibias employment law. In particular, the act protects workers over forty years of age and prohibits forced retirement in most jobs because of age. Until 1987, federal law had permitted mandatory retirement at age seventy, but the 1986 amendments that took effect January 1, 1987, abolished the age ceiling except for a few jobs, such as firefighters, police officers, tenured university professors, and executives with annual pensions exceeding $44,000. Like Title VII, the law has a BFOQ exception—for example, employers may set reasonable age limitations on certain high-stress jobs requiring peak physical condition.

There are important differences between the ADEA and Title VII, as *Gross v. FBL Financial Services, Inc.* (Section 16.4.3 "Age Discrimination: Burden of Persuasion") makes clear. It is now more difficult to prove an age discrimination claim than a claim under Title VII.

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 16.4.4 "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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4.3: Employment at Will

Learning Objectives

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

- Understand what is meant by employment at will under common law.
- Explain the kinds of common-law (judicially created) exceptions to the employment-at-will doctrine, and provide examples.

At common law, an employee without a contract guaranteeing a job for a specific period was an **employee at will** and could be fired at any time and for any reason, or even for no reason at all. The various federal statutes we have just examined have made inroads on the at-will doctrine. Another federal statute, the Occupational Safety and Health Act, prohibits employers from discharging employees who exercise their rights under that law.

The courts and legislatures in more than forty states have made revolutionary changes in the at-will doctrine. They have done so under three theories: tort, contract, and duty of good faith and fair dealing. We will first consider the tort of wrongful discharge.

Courts have created a major exception to the employment-at-will rule by allowing the tort of wrongful discharge. *Wrongful discharge* means firing a worker for a bad reason. What is a bad reason? A bad reason can be:

1. discharging an employee for refusing to violate a law,
2. discharging an employee for exercising a legal right,
3. discharging an employee for performing a legal duty, and
4. discharging an employee in a way that violates public policy.

Discharging an Employee for Refusing to Violate a Law

Some employers will not want employees to testify truthfully at trial. In one case, a nurse refused a doctor's order to administer a certain anesthetic when she believed it was wrong for that particular patient; the doctor, angry at the nurse for refusing to obey him, then administered the anesthetic himself. The patient soon stopped breathing. The doctor and others could not resuscitate him soon enough, and he suffered permanent brain damage. When the patient's family sued the hospital, the hospital told the nurse she would be in trouble if she testified. She did testify according to her oath in the court of law (i.e., truthfully), and after several months of harassment, was finally fired on a pretext. The hospital was held liable for the tort of wrongful discharge. As a general rule, you should not fire an employee for refusing to break the law.

Discharging an Employee for Exercising a Legal Right

Suppose Bob Berkowitz files a claim for workers' compensation for an accident at Pacific Gas & Electric, where he works and where the accident that injured him took place. He is fired for doing so, because the employer does not want to have its workers' comp premiums increased. In this case, the right exercised by Berkowitz is supported by public policy: he has a legal right to file the claim, and if he can establish that his discharge was caused by his filing the claim, he will prove the tort of wrongful discharge.

Discharging an Employee for Performing a Legal Duty

Courts have long held that an employee may not be fired for serving on a jury. This is so even though courts do recognize that many employers have difficulty replacing employees called for jury duty. Jury duty is an important civic obligation, and employers are not permitted to undermine it.

Discharging an Employee in a Way That Violates Public Policy

This is probably the most controversial basis for a tort of wrongful discharge. There is an inherent vagueness in the phrase "basic social rights, duties, or responsibilities." This is similar to the exception in contract law: the courts will not enforce contract provisions that violate public policy. (For the most part, public policy is found in statutes and in cases.) But what constitutes public policy is an important decision for state courts. In *Wagenseller v. Scottsdale Memorial Hospital*,*Wagenseller v. Scottsdale Memorial Hospital*, 147 Ariz. 370; 710 P.2d 1025 (1085). 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 16.4.4 “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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4.4: Other Employment-Related Laws

Learning Objectives

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

- Understand the various federal and state statutes that affect employers in the areas of plant closings, pensions, workers' compensation, use of polygraphs, and worker safety.

The Federal Plant-Closing Act

A prime source of new jobs across the United States is the opening of new industrial plants—which accounted for millions of jobs a year during the 1970s and 1980s. But for every 110 jobs thus created, nearly 100 were lost annually in plant closings during that period. In the mid-1980s alone, 2.2 million plant jobs were lost each year. As serious as those losses were for the national economy, they were no less serious for the individuals who were let go. Surveys in the 1980s showed that large numbers of companies provided little or no notice to employees that their factories were to be shut down and their jobs eliminated. Nearly a quarter of businesses with more than 100 employees provided no specific notice to their employees that their particular work site would be closed or that they would suffer mass layoffs. More than half provided two weeks' notice or less.

Because programs to support dislocated workers depend heavily on the giving of advance notice, a national debate on the issue in the late 1980s culminated in 1988 in Congress's enactment of the Worker Adjustment and Retraining Notification (WARN) Act, the formal name of the federal plant-closing act. Under this law, businesses with 100 or more employees must give employees or their local bargaining unit, along with the local city or county government, at least sixty days' notice whenever (1) at least 50 employees in a single plant or office facility would lose their jobs or face long-term layoffs or a reduction of more than half their working hours as the result of a shutdown and (2) a shutdown would require long-term layoffs of 500 employees or at least a third of the workforce. An employer who violates the act is liable to employees for back pay that they would have received during the notice period and may be liable to other fines and penalties.

An employer is exempted from having to give notice if the closing is caused by business circumstances that were not reasonably foreseeable as of the time the notice would have been required. An employer is also exempted if the business is actively seeking capital or business that if obtained, would avoid or postpone the shutdown and the employer, in good faith, believes that giving notice would preclude the business from obtaining the needed capital or business.

The Employee Polygraph Protection Act

Studies calling into question the reliability of various forms of lie detectors have led at least half the states and, in 1988, Congress to legislate against their use by private businesses. The Employee Polygraph Protection Act forbids private employers from using lie detectors (including such devices as voice stress analyzers) for any reason. Neither employees nor applicants for jobs may be required or even asked to submit to them. (The act has some exceptions for public employers, defense and intelligence businesses, private companies in the security business, and manufacturers of controlled substances.)

Use of polygraphs, machines that record changes in the subject's blood pressure, pulse, and other physiological phenomena, is strictly limited. They may be used in conjunction with an investigation into such crimes as theft, embezzlement, and industrial espionage, but in order to require the employee to submit to polygraph testing, the employer must have "reasonable suspicion" that the employee is involved in the crime, and there must be supporting evidence for the employer to discipline or discharge the employee either on the basis of the polygraph results or on the employee's refusal to submit to testing. The federal polygraph law does not preempt state laws, so if a state law absolutely bars an employer from using one, the federal law's limited authorization will be unavailable.

Occupational Safety and Health Act

In a heavily industrialized society, workplace safety is a major concern. Hundreds of studies for more than a century have documented the gruesome toll taken by hazardous working conditions in mines, on railroads, and in factories from tools, machines, treacherous surroundings, and toxic chemicals and other substances. Studies in the late 1960s showed that more than 14,000 workers were killed and 2.2 million were disabled annually—at a cost of more than $8 billion and a loss of more than 250 million

worker days. Congress responded in 1970 with the Occupational Safety and Health Act, the primary aim of which is "to assure so far as possible every working man and woman in the Nation safe and healthful working conditions."

The act imposes on each employer a general duty to furnish a place of employment free from recognized hazards likely to cause death or serious physical harm to employees. It also gives the secretary of labor the power to establish national health and safety standards. The standard-making power has been delegated to the Occupational Safety and Health Administration (OSHA), an agency within the US Department of Labor. The agency has the authority to inspect workplaces covered by the act whenever it receives complaints from employees or reports about fatal or multiple injuries. The agency may assess penalties and proceed administratively to enforce its standards. Criminal provisions of the act are enforced by the Justice Department.

During its first two decades, OSHA was criticized for not issuing standards very quickly: fewer than thirty national workplace safety standards were issued by 1990. But not all safety enforcement is in the hands of the federal government: although OSHA standards preempt similar state standards, under the act the secretary may permit the states to come up with standards equal to or better than federal standards and may make grants to the states to cover half the costs of enforcement of the state safety standards.

Employee Retirement Income Security Act

More than half the US workforce is covered by private pension plans for retirement. One 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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4.5: 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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4.6: 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 CHECK QUESTIONS

1. Affirmative action in employment
    1. is a requirement of Title VII of the Civil Rights Act of 1964
    2. is prohibited by Title VII of the Civil Rights Act of 1964
    3. is a federal statute enacted by Congress
    4. depends on the circumstances of each case for validity
2. The Age Discrimination in Employment Act protects
    1. all workers of any age
    2. all workers up to age seventy
    3. most workers over forty
    4. no workers over seventy
3. Federal laws barring discrimination against the handicapped and disabled
    1. apply to all disabilities
    2. apply to most disabilities in private employment
    3. apply to all disabilities in public employment
    4. apply to most disabilities in public employment
4. Under Title VII, a bona fide occupational qualification exception may never apply to cases involving
    1. racial discrimination
    2. religious discrimination
    3. sex discrimination
    4. age discrimination
5. The employment-at-will doctrine derives from
    1. Title VII of the Civil Rights Act of 1964
    2. employment contracts
    3. the common law
    4. liberty of contract under the Constitution

AnswerS

1. d
2. c

3. b
4. a
5. c

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CHAPTER OVERVIEW

5: Employment Discrimination

5.1: Introduction

5.2: Overview of Title VII of the Civil Rights Act of 1964

5.3: Enforcement of Title VII

5.4: Other Federal Antidiscrimination Laws

5.5: Concluding Thoughts

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5.1: Introduction

Learning Objectives

Great strides have been made in recent decades in eliminating the smears of discrimination from many facets of society such as voting rights, property ownership, and education. In the workplace, however, systematic discrimination continues to take its toll on many. This chapter explores workplace discrimination and examines the legal remedies available to those who believe they may be victims of discrimination. After reading this chapter, you should be able to answer the following questions:

- What are the various civil rights statutes that govern employment discrimination?
- What legal theories govern recovery discrimination lawsuits?
- How can businesses steer clear of liability for discrimination?

Figure 12.1.1 "An Abercrombie & Fitch Billboard in New York City" shows a billboard for Abercrombie & Fitch (or A&F, as it's sometimes known), a clothing retailer. The Columbus, Ohio–based company generates nearly $2 billion in sales annually by selling clothes in retail locations throughout North America, Europe, and Asia. As the billboard suggests, A&F's marketing concept (which it calls "Casual Luxury") is based heavily on portraying a certain image. How would you characterize that image? If you used adjectives like athletic, young, all-American, sexy, or attractive, you would be correctly identifying the company's strategy. The strategy works as it has helped the company generate hundreds of millions in profits for its shareholders.

A&F relies on a message that boils down to convincing its young consumers that by wearing A&F clothing, they will also be young, athletic, and attractive. If consumers don't believe that message, they will likely abandon the brand for another in this hugely competitive segment. To maintain the authenticity of that marketing message, A&F rigorously hires only models that fit a certain image in print and Web advertising. It extends this practice to store workers so that any time a customer interacts with A&F, that brand image is reinforced.



Figure 5.1.1: An Abercrombie & Fitch Billboard in New York City. Source: Photo courtesy of FaceMePLS, http://www.flickr.com/photos/faceme/2536281153.

Is it illegal for A&F to hire only "attractive" people to work in its stores? The answer is no, just as it's not illegal for *Vogue* magazine to hire only attractive models, or for a cosmetics company to hire only salespeople with clear skin. Under the employment-at-will doctrine, workers in the United States are free to work for whomever they want to (or not work at all), and employers are free to hire whomever they want to, and fire them at will. The vast majority of workers in the United States are covered by the at-will doctrine.

If you came in to work with green hair, you could be fired. If you came in to work with a visible body piercing or tattoo, you could be fired. If you get into an argument with your boss about whether baseball or basketball is a better sport, you could get fired. Companies can fire workers for smoking cigarettes, even at home. Companies can fire employees who say anything disparaging or negative about their bosses or the company, even on a private Facebook page. Narrow exceptions lie in the law, such as a company that enters into a written contract to hire a worker for a specified period of time. (Even then, many employment contracts specify

at-will status for the worker.) If A&F wishes to engage in "looks-based" discrimination and refuses to hire workers who are overweight, ugly, or have pimples, then it is free to do so under U.S. law.

A problem arises, however, if "all-American casual luxury" starts to suspiciously become another way to say "all-white." Many of A&F's competitors, such as Gap, Aéropostale, American Eagle, and J. Crew, market their clothes on a similar "all-American" theme, but their models and store workers tend to look more diverse than those at A&F. If A&F is using its "beautiful people only" marketing to hide a more sinister plan to discriminate against racial minorities, then A&F is breaking the law.

Hyperlink: Abercrombie & Fitch Settles Discrimination Suit

http://www.npr.org/templates/story/story.php?storyId=4174147

In 2004 several former workers at A&F as well as job applicants denied employment filed a lawsuit against A&F for racial discrimination. The company paid $50 million to settle the claim and hired a vice president for diversity.

Discrimination, then, is not always illegal. A&F can discriminate against ugly people and *Vogue* can discriminate against fat people. When is discrimination illegal? Under what circumstances can employers draw lines of classification within the general population? When does a person fall into a protected class that the law recognizes? What must a disappointed worker be able to prove to demonstrate illegal discrimination? In this chapter, we'll explore these issues so that as future business professionals, you'll have a sense of what you can and cannot do when it comes to hiring, managing, and firing employees.

Key Takeaways

Workers in the United States are hired and fired at will, meaning they can be hired or fired for any reason and at any time. Workers in a protected class may be protected if they can demonstrate that they were discriminated against because they were members of a protected class.

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5.2: Overview of Title VII of the Civil Rights Act of 1964

Learning Objectives

- Learn about the history of the Civil Rights Act.
- Understand who has to comply with the Civil Rights Act.
- Explore what employment practices are protected by the Civil Rights Act.
- Study the procedures involved with the Equal Employment Opportunity Commission.

Hyperlink: Kennedy Calls for Legislative Action on Civil Rights

www.jfklibrary.org/Historical+Resources/Archives/Reference+Desk/Speeches/JFK/003POF03CivilRights06111963.htm

On June 11, 1963, President John F. Kennedy delivered a speech to the nation describing the peaceful resolution to a tense standoff in Alabama after a federal court ordered the admission of two black students to the University of Alabama. He used the occasion to rail against continued discrimination against African Americans a century after the Civil War. “Next week I shall ask the Congress to act, to make a commitment it has not fully made in this century to the proposition that race has no place in American life or law…I am asking Congress to enact legislation giving all Americans the right to be served in facilities which are open to the public—hotels, restaurants, retail stores, and similar establishments. This seems to me to be an elementary right. Its denial is an arbitrary indignity that no American in 1963 should have to endure, but many do.” You can listen to the entire speech, and read the transcript of the speech, through the hyperlink.



Figure 5.2.1: President John F. Kennedy made passage of the Civil Rights Act a key part of his presidency. Source: Photo courtesy of Abbie Rowe, National Park Service, www.jfklibrary.org/Asset+Tree/Asset+Viewers/Image+Asset+Viewer.htm?guid={0AFA0FD7-9DBA-4467- B051-44A6DD69C48A}&type=Image.

In 1963 President Kennedy called for the passage of a sweeping civil rights bill in response to intransigent racial segregation. The bill was vehemently opposed by many in Congress, including avowed segregationists who saw the bill as an intrusion on states’ rights. Kennedy was assassinated before he could see the bill passed into law, but his successor President Johnson carried Kennedy’s wish forward through aggressive lobbying of Congress to pass the bill. At its core, the bill was designed to integrate

African Americans into the mainstream of American society. Today, the Civil Rights Act of 1964 has broad significance for all racial minorities, religious organizations, and women.

The bill has several provisions, but the most important for businesses is known widely as “Title VII.” It applies to employers with more than fifteen employees. It eliminates job discrimination on the basis of:

- Race
- Color
- Religion
- Sex
- National origin

Any act of discrimination on any of these bases is illegal. These acts may be a refusal to hire, a discharge or termination, a temporary layoff or retrenchment, compensation, an opportunity for advancement, or any other term or condition of employment. For example, employers are not permitted to maintain all-white or all-black work crews even if they can demonstrate that doing so is good for business or morale. Title VII also prohibits acts of retaliation against anyone who complains about, or participates in, any employment discrimination complaint. Employers need to be very careful about this provision, because while the employer may be innocent of the first charge of discrimination, taking any subsequent action after an employee has complained can be a separate charge of discrimination. Once an employee has made a complaint of discrimination, it is very important that the employer not alter any condition of his or her employment until the complaint has been resolved.

The law does, however, allow discrimination on religion, sex, and national origin if there is a bona fide occupational qualification (BFOQ) reasonably necessary for normal business operations. For example, a Jewish synagogue may restrict hiring of rabbis to Jewish people only, and a Catholic church can restrict hiring priests to Catholic men only. A nursing home that caters exclusively to elderly women and is hiring personal assistants to help the patients with personal hygiene and dressing may restrict hiring to women only as a BFOQ. Victoria’s Secret can legally discriminate against men in finding models to advertise and market their products. A movie producer can legally discriminate between men and women when casting for certain roles such as a woman to play Bella and a man to play Edward in the popular *Twilight* series. Since BFOQ discrimination extends to national origin, a play producer casting for a role that specifically calls for a Filipino can legally restrict hiring to Filipinos only. A gentlemen’s club can hire women only as a BFOQ.

Managers should be very careful in applying BFOQ discrimination. It is an exception that is very much based on individual cases and subject to strict interpretation. The BFOQ must be directly related to an essential job function to be “bona fide.” Customer preference is not a basis for BFOQ. For example, a taxi company cannot refuse to hire women as taxi drivers even if the company claims that customers overwhelmingly prefer male drivers, and airlines cannot refuse to hire men even if surveys show customers prefer female flight attendants.

Hyperlink: Men and Hooters

www.time.com/time/magazine/article/0,9171,987169,00.html

The Hooters restaurant chain hires scantily clad women exclusively as servers, refusing to hire men for that role. Men are hired for other roles such as kitchen staff and hosts. In 1997 a group of men sued Hooters for sex discrimination. Without admitting any wrongdoing, Hooters settled the claim. Hooters says that its policy of hiring only women to act as servers is a bona fide occupational qualification. What do you think?

Hooters has also been accused by women’s groups of only hiring women who fit a certain profile that discriminates against anyone who management deems to be unattractive or overweight. Do you believe Hooters should be able to take these factors into account when making hiring decisions?

Note that race and color are not on the list of acceptable BFOQs. This means that in passing the law, Congress made a determination that there is no job in the United States where race or color is a bona fide occupational qualification. A country-and-western-themed restaurant, for example, may not hire only white people as wait staff.

Title VII creates only five protected classes. Various other federal and state laws, discussed in Chapter 12 "Employment Discrimination", Section 12.4 "Other Federal Antidiscrimination Laws", create other protected classes. Many other classes, such as weight, attractiveness, and height, are not on the list of protected classes. Contrary to popular belief, there is also no federal law that protects against discrimination on the basis of sexual orientation. National restaurant chain Cracker Barrel, for example, for many years maintained an open policy of not hiring homosexuals and dismissing any person who came out at work. It was only under pressure from shareholder activists that the company finally rescinded its discriminatory policy.

Hyperlink: The Employment Non-Discrimination Act

http://www.npr.org/templates/story/story.php?storyId=113719460

Since 2007 Congress has been debating the Employment Non-Discrimination Act (ENDA). The law would specifically prohibit employment discrimination on the basis of sexual orientation. The House passed the bill in 2007, but it died in the Senate. In 2009 new attempts were made at passing the law, but strident partisanship once again ended chances of passage, as this NPR story explains. Do you believe this law should be passed? If it passes, do you see an inconsistency with the Defense of Marriage Act, which prohibits federal recognition of same-sex marriage?

Note too that Title VII does not prohibit all discrimination. Employers are free to consider factors such as experience, business acumen, personality characteristics, and even seniority, as long as those factors are related to the job in question. Title VII requires employers to treat employees equally, but not identically.

Title VII is a federal law, but it does not give victims of discrimination the immediate right to file a federal lawsuit. Instead, Title VII created a federal agency, the Equal Employment Opportunity Commission (EEOC) to enforce civil rights in the workplace. The EEOC publishes guidelines and interpretations for the private sector to assist businesses in deciding what employment practices are lawful or unlawful. The EEOC also investigates complaints filed by workers who believe they are victims of unlawful discrimination. If the EEOC believes that unlawful discrimination has taken place, the EEOC can file charges against the employer. Even if the employee has signed a predispute arbitration clause with the employer agreeing to send employment disputes to arbitration, the Supreme Court has ruled that the predispute arbitration clause does not extend to the EEOC, which can still file a lawsuit on the employee's behalf in federal court.*EEOC v. Waffle House, Inc.*, 534 U.S. 279 (2002).



Figure 5.2.2: Lilly Ledbetter. A jury found Lilly Ledbetter was the victim of regular pay discrimination at Goodyear because of her gender. Source: Photo courtesy of aflcio, http://www.flickr.com/photos/labor20...in/photostream.

Employees must file Title VII charges with the EEOC first before going to court. If the EEOC investigates and decides not to pursue the case any further, the EEOC can issue a "right to sue" letter. With that letter, the employee can then file a case in federal court within 90 days of the date of the letter. Any EEOC complaint must be filed within 180 days of the alleged discriminatory act taking place. This deadline is generally extended to 300 days if there is a state agency that enforces a state law prohibiting discrimination on the same basis. If employees wait beyond 180 or 300 days, their claims will be dismissed. The question of when the clock begins was the subject of much debate recently when a female manager at Goodyear, Lilly Ledbetter (Figure 12.2.2 "Lilly

Ledbetter"), discovered she had been paid unequally compared to males for many years. She filed a Title VII lawsuit in federal court and won several million dollars in damages. At the Supreme Court, however, a narrow 5–4 majority opinion authored by Justice Alito held that she had to file her claim within 180 days of any decision to pay her unequally, which had happened many years ago. *Ledbetter v. Goodyear Tire & Rubber Co.*, 550 U.S. 618 (2007). She, therefore, lost her case and her damages award. In response, Congress passed the Lily Ledbetter Fair Pay Act of 2009, which gives victims the right to file a complaint within 180 days of their last discriminatory paycheck.

The EEOC has the authority to award several remedies to victims of discrimination. These include the award of back pay for any lost wages, the issuance of an injunction to stop the employer from making any continuing acts or policies of discrimination, ordering a terminated or demoted employee reinstated to his or her prior position, and the award of compensatory damages for out-of-pocket costs resulting from the discrimination as well as emotional harm. Attorneys' fees may also be recoverable. In cases of severe or reckless discrimination, punitive damages are also available. Punitive damages are capped by amendments to Title VII passed in 1991. These caps start at $50,000 for employers with less than one hundred employees and rise to $300,000 for employers with more than five hundred employees.

Anyone who files a Title VII claim in federal court must prove his or her claim using one of two possible theories. The first theory, known as disparate treatment, alleges that the defendant employer acted intentionally to discriminate against the victim because of the victim's membership in a protected class. Winning a disparate treatment case is very hard because it essentially requires proof that the defendant acted intentionally, such as a statement by the defendant that it is not hiring someone because of that person's race, an e-mail to the same effect, or some other sort of "smoking gun" evidence. If a defendant wants to discriminate against someone illegally in the workplace, it is very unusual for it to say so explicitly since under the at-will doctrine, it is easy for an employer to find a lawful reason to discriminate.

Under Supreme Court precedent, a plaintiff wishing to demonstrate disparate treatment has to first make out a prima facie case of discrimination, which involves demonstrating that he or she is a member of a protected class of workers.*McDonnell Douglas v. Green*, 411 U.S. 792 (1973). He or she applied for a job that he or she is qualified for, and the employer chose someone else outside of the plaintiff's class. Once that demonstration has been made, the employer can rebut the presumption of discrimination by arguing that a legitimate, nondiscriminatory reason existed for taking the adverse action against the plaintiff. If the employer can state such a legitimate reason, then the burden of proof shifts back to the employee again, who must then prove by a preponderance of evidence that the employer's explanation is insufficient and only a pretext for discrimination. This last step is very difficult for most victims of intentional discrimination.

If a victim is unable to find proof of disparate treatment, he or she may instead use a theory called disparate impact, where the discrimination is unintentional. Most Title VII cases fall into this category because it is so rare to find proof of the intentional discrimination required in disparate treatment cases. In a disparate impact case, the victim alleges that the defendant has adopted some form of race-neutral policy or employment practice that, when applied, has a disproportionate impact on certain protected classes. If a victim successfully demonstrates a disparate impact, then the employer must articulate a nondiscriminatory business necessity for the policy or practice. The Supreme Court first articulated this theory in 1971 in a case involving a power company that implemented an IQ test and high school diploma requirement for any position outside its labor department, resulting in very few African Americans working at the power company other than in manual labor. The Court held that the Civil Rights Act "proscribes not only overt discrimination, but also practices that are fair in form, but discriminatory in operation. The touchstone is business necessity."*Griggs v. Duke Power Co.*, 401 U.S. 424 (1971). In that case, the Court found that the power company could not prove a business necessity for having the IQ tests or high school diploma requirement, so those practices were ruled illegal.

Business policies that raise suspicions for disparate impact include educational qualifications, written tests, intelligence or aptitude tests, height and weight requirements, credit checks, nepotism in hiring, and subjective procedures such as interviews. Businesses that have these sorts of policies need to be very careful that the policies are directly related to and necessary for the job function under consideration. In one recent case, the city of Chicago received more than twenty-six thousand applications for firefighters in 1995 for only several hundred positions. The city required all the applicants to take a test, and it used that test to categorize applicants as failing, qualified, or well-qualified. Faced with so many applicants, the city decided to hire only candidates who received a well-qualified score. African Americans made up 45 percent of the qualified group, but only 11.5 percent of the well-qualified group, so the decision had an adverse and disparate impact on a protected class. More than ten years later and after an appeal all the way to the Supreme Court on the question of timeliness of their lawsuit, the plaintiffs are still waiting for a trial on

whether the city acted illegally. *Lewis v. Chicago*, 560 U.S. ___ (2010), http://www.law.cornell.edu/supct/html/08-974.ZS.html (accessed September 27, 2010).

Proving a disparate impact case is not easy for victims of discrimination. It is not enough for the employee to use statistics alone to point out that a job policy or practice has a disparate impact on the victim's protected class. In addition, the 1991 amendments to the Civil Rights Act prohibited the use of race norming in employment testing.

Key Takeaways

The 1964 Civil Rights Act is a major piece of legislation that affects virtually all employers in the United States. Originally created to ensure the integration of African Americans into mainstream society, the law prohibits discrimination on the basis of race, color, religion, sex, and national origin. Some forms of discrimination on the basis of religion, sex, or national origin are permitted if they are bona fide occupational qualifications. Federal law does not prohibit discrimination on the basis of sexual orientation. The Equal Employment Opportunity Commission investigates charges of illegal workplace discrimination. These charges must be filed by workers within 180 days of the alleged discriminatory act taking place. If a worker believes intentional discrimination has taken place, he or she may pursue a theory of disparate treatment in his or her lawsuit. If the discrimination is unintentional, the worker may pursue a theory of disparate impact. Employment practices that have a disparate impact on members of a protected class are permissible, however, if they are job-related and qualify as a business necessity.

? Exercise 5.2.1

1. More than four decades after the passage of the 1964 Civil Rights Act, many libertarians and conservatives continue to believe that the law is a violation of states' rights. Do you agree? Why or why not?
2. In listening to President Kennedy's speech, do you believe that the promise held by the Civil Rights Act has been met? Why or why not?
3. Businesses sometimes discriminate against their customers on the basis of sex. A bar may charge females a reduced or waived cover charge in a "Ladies Night" promotion, for example, to increase the female ratio in their audience. Hair salons routinely charge more for services to women, and even dry cleaners charge higher prices for cleaning women's clothes. Do you believe these forms of discrimination should be illegal? Why or why not?
4. Research demonstrates that taller, more athletic, and more attractive people earn more in the workplace than shorter, less fit, or less attractive people. Do you believe this is unfair, and if so, do you believe the law should be amended to protect these classes?
5. Race and color can never be BFOQs. Does that mean that an African American actor could play Abraham Lincoln in a movie reenactment of Lincoln's life? Why or why not?

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5.3: Enforcement of Title VII

Learning Objectives

- Explore what the protections of the Civil Rights Act mean.
- Understand implications of the Civil Rights Act for employers and employment practices.
- Examine how businesses can protect themselves against claim of discrimination.

Many times in the business world, it pays to be exceptional and different. Standing out from the crowd allows an employee to be noticed for exceptional performance and can lead to faster and greater advancement. In some other respects, however, standing out for being a racial or ethnic minority, or for being a woman, can be incredibly uncomfortable for employees. Learning to celebrate differences appropriately remains a challenge for many human resource professionals.

The main purpose of Title VII was to integrate African Americans into the mainstream of society, so it's no surprise that charges of race-based discrimination continue to generate the highest number of complaints to the Equal Employment Opportunity Commission (EEOC). In 2009 the EEOC received nearly thirty-four thousand complaints of race-based discrimination in the workplace, representing 36 percent of the total number of complaints filed.U.S. Equal Employment Opportunity Commission, "Charge Statistics FY 1997 through FY 2009," http://eeoc.gov/eeoc/statistics/enforcement/charges.cfm (accessed September 27, 2010). Intentional discrimination against racial minorities is illegal, but as discussed earlier in this section, proving intentional discrimination is exceedingly difficult. That means the EEOC pays close attention to disparate impact cases in this area.

Hyperlink: Diversity Day at *The Office*

http://www.nbc.com/The_Office/video/diversity-day/116137

In NBC's hit sitcom *The Office*, Michael Scott is the hapless and often clueless manager of a paper company's branch office in Pennsylvania. In this clip, he decides to celebrate Diversity Day by having the employees engage in an exercise. He has written certain ethnicities and nationalities on index cards and taped them to employees' foreheads. The employee does not know what his or her card says and is supposed to figure it out through interactions with other employees. The results are a less-than-stellar breakthrough in an understanding of diversity. Does your school or university celebrate in diversity celebrations? Do you believe these celebrations are helpful or unhelpful in the workplace?

For example, an employer policy to examine the credit background of employees might be suspect. Statistically, African Americans have poorer credit than white Americans do, so this policy will necessarily reduce the number of African Americans who can qualify for the position. While a credit check may be a business necessity for a job requiring a high level of trustworthiness, it is hardly necessary for all positions. Similarly, sickle-cell anemia is a blood disease that primarily affects African Americans. An employer policy that excludes persons with sickle-cell anemia must be job-related and a business necessity to be legal. A "no-beard" employment policy may also be problematic for African Americans. Many African American men suffer from a medical skin condition that causes severe and painful bumps if they shave too closely, requiring them to keep a beard. A no-beard policy will therefore have to be justified by business necessity. For example, a firefighter may be required to be beard-free if a beard interferes with the proper functioning of an oxygen mask, a critical piece of equipment when fighting fires. White persons can be victims of race or color discrimination as well. A tanning salon cannot refuse to hire a very light-skinned person of Irish descent, for example, if its refusal is based on color appearance of the job candidate.

To correct past mistakes in treatment of women and minorities, many companies go beyond being equal opportunity employers by adopting affirmative action programs. Companies are not required to undertake affirmative action programs, but many do. In some instances, they do so to qualify as a federal contractor or subcontractor. Under Executive Order 11246, most federal contractors or subcontractors must develop an annual affirmative action plan and take "affirmative steps" to recruit, hire, and train females and minorities in the workforce. Even companies that do not seek to sell to the federal government may voluntarily undertake affirmative action programs, as long as those programs are meant to correct an imbalance in the workforce, are temporary, and do not unnecessarily infringe on the rights of nonbeneficiaries.

Affirmative action plans can be tricky to administer because white Americans can also be the victims of race discrimination or so-called reverse discrimination. The provisions of Title VII are meant to protect all Americans from race discrimination. One of the earliest cases of reverse discrimination took place in 1981, when a white air traffic controller successfully sued the Federal Aviation Administration (FAA), claiming the FAA had hired women and racial minorities over him. In one recent case, the fire department in the city of New Haven conducted a management test to decide which firefighters to promote. When no black firefighters passed the test, the city decided to invalidate the test. Nineteen firefighters who did pass the test (all white or Hispanic) filed suit, alleging the city's actions violated Title VII. The Supreme Court found in favor of the firefighters, holding that the city's fear of a discrimination lawsuit from minorities if it went forward with the test was not enough justification to discriminate against the white firefighters.*Ricci v. DeStefano*, 557 U.S. ___ (2009), http://www.law.cornell.edu/supct/html/07-1428.ZS.html (accessed October 2, 2010).

A related form of discrimination is discrimination on the basis of national origin, which is also prohibited by Title VII. This involves treating workers unfavorably because of where they are from (specific country or region) or ethnicity. It is illegal to discriminate against a worker because of his or her foreign accent unless it seriously interferes with work performance. Workplace "English-only" rules are also illegal unless they are required for the job being performed. While English-only rules might be a business necessity for police officers, they would not be for late-night office cleaners.

Hyperlink: Sikhs Regain Right to Wear Turbans in U.S. Army

http://www.npr.org/templates/story/story.php?storyId=125142736

Members of one of the world's oldest religions, Sikhism, do not cut their hair and wear their hair in a turban. Since 1984 this has been prohibited by the U.S. Army, which has standards for both hair and facial hair for recruits. In 2010 the army lifted this prohibition, resulting in the first Sikh Army officer, Captain Tejdeep Singh Rattan (Figure 12.3.1 "Captain Tejdeep Singh Rattan, the First Sikh Army Officer"), in more than twenty-five years, as this NPR story explains.



Figure 5.3.1: Captain Tejdeep Singh Rattan, the First Sikh Army Officer. Source: Photo courtesy of the U.S. Army, http://www.flickr.com/photos/soldiersmediacenter/4464653659/sizes/o.

Title VII's prohibition on religious discrimination has raised some interesting workplace issues. The law makes it illegal to treat an employee unfavorably because of his or her religious beliefs. Furthermore, employees cannot be required to participate in any religious activity as a condition of employment. It extends protection not just to major religions such as Buddhism, Christianity, Hinduism, Islam, and Judaism but also to anyone who has sincerely held religious or moral beliefs.

Additionally, employers must reasonably accommodate an employee's religious beliefs or practices as long as it does not cause an undue hardship on the employer's operation of its business. Typically, this would involve being flexible in schedule changes or leaves. A Muslim worker who asked for a few short breaks a day to pray, for example, might be reasonable for an administrative

assistant but not for a police officer or air traffic controller. Issues of dress and appearance are often grounds for charges of religious discrimination. For example, if a Muslim woman wished to wear a *hijab*, or traditional headscarf, then she should be permitted to do so unless it places an undue hardship on operations. In 2010, UPS agreed to settle a case with the EEOC, paying $46,000 in damages for firing a driver who refused to cut his hair or shave his beard, which the driver believes would violate tenets of his Rastafarian religion.U.S. Equal Employment Opportunity Commission, "UPS Freight to Pay $46,000 to Settle EEOC Religious Discrimination Lawsuit," February, 17, 2010, http://eeoc.gov/eeoc/newsroom/release/2-17-10.cfm (accessed September 27, 2010).

A very interesting recent development of workplace discrimination arises when a worker refuses to carry out his or her job duties because of a sincerely held moral belief that doing so would promote immoral activity. For example, after the Food and Drug Administration approved sale of the so-called "morning after" pill to prevent unwanted pregnancy, some pharmacists refused to fill prescriptions for the drug, claiming it was against their religious beliefs to do so. Another example arose in Minnesota in 2006 when a bus driver refused to drive a bus carrying an advertisement for a gay-themed newspaper. Courts and legislatures continue to struggle with where to draw the line between respecting employees' religious beliefs and the rights of employers to insist their workers perform essential job functions.

Finally, Title VII prohibits discrimination on the basis of sex. Interestingly, the inclusion of sex as a protected class in Title VII was a legislative maneuver designed to kill the bill while it was being debated in Congress. Howard Smith, a Democrat from Virginia, strongly opposed the 1964 Civil Rights Act and thought that by adding the word "sex" to the list of protected classes, the bill would become so poisonous that it would fail passage. In fact, the bill quickly passed, and it led former Chief Justice Rehnquist to complain that courts were, therefore "left with little legislative history to guide us in interpreting the Act's prohibition against discrimination based on sex." *Meritor Savings Bank v. Vinson*, 477 U.S. 57 (1986).



Figure 5.3.2: An Advertisement for PSA Airlines. Source: gulfnews.com/polopoly_fs/an-airline-advertisement-of-the-1960s-1.564441!image/4155641854.jpg_gen/derivatives/box_475/4155641854.jpg.

The prohibition on sex discrimination means that employers cannot categorize certain jobs as single-sex only unless a bona fide occupational qualification (BFOQ) applies. Customer preferences or market realities are not the basis for BFOQ. For example, a job that requires heavy lifting cannot be categorized as male-only since a woman may qualify after passing a physical test. As society has changed, much progress has been made in this area of equal employment opportunity. Airlines, for example, used to routinely hire predominantly single young women as flight attendants (Figure 12.3.2 "An Advertisement for PSA Airlines"). Male cabin crew could marry, but women could not. Those distinctions have now been erased, partially because of Title VII, and partially because of societal attitudes.

The prohibition against sex discrimination also includes making stereotypical assumptions about women simply because they might be the primary caregiver to children at home. If there are two job applicants, for example, and both have young children at home, it would be illegal to give preference to the male candidate over the female candidate. Once a female employee has children, it would be illegal to assume that she is less committed to her job, or would like to work fewer hours. It's important to note that

these protections extend to men as well. If an employer voluntarily provides time off to new mothers, for example, it must extend identical benefits to new fathers.

Discrimination on the basis of sex can also take the form of workplace sexual harassment. Contrary to popular belief, there isn't an actual statute that makes sexual harassment illegal. Instead, sexual harassment is the product of judicial interpretation of what it means to discriminate on the basis of sex. Courts have generally recognized two forms of sexual harassment. The first, known as quid pro quo, involves asking for sexual favors in return for job opportunities or advancement. Courts reason that if a male worker asks a female worker for sex in return for favorable treatment, it is because that worker is female, and therefore a Title VII violation has occurred. If a supervisor fires a subordinate for breaking up with him or her, then quid pro quo harassment has taken place.

Another type of sexual harassment is known as the hostile work environment. First recognized by the Supreme Court in 1986, a hostile work environment is one where hostile conditions in the workplace are severe and pervasive, unwelcome, and based on the victim's gender. *Meritor Savings Bank v. Vinson*, 477 U.S. 57 (1986). Courts are careful not to impose manners on workplaces, so an offhand remark or dirty joke is unlikely to be sexual harassment. To be considered sexual harassment, the harassment must be so severe or pervasive that it alters the conditions of the victim's employment. In one recent case, the EEOC collected $471,000 for thirteen female telemarketers from a firm providing basement waterproofing services. The harassment by male managers and coworkers at the firm included repeated requests for sex, frequent groping, sexual jokes, and constant comments about the bodies of women employees.U.S. Equal Employment Opportunity Commission, "EEOC Collects $471,000 Jury Award after Winning Appeal from Waterproofing Company in Sex Harassment Case," May 5, 2010, http://www.eeoc.gov/eeoc/newsroom/release/5-5-10.cfm (accessed September 27, 2010). Similar cases involve workplace atmospheres where women are heckled with sexual comments, propositioned for sex, made to listen to crude sexual comments or comments about their bodies, subject to pornography in the workplace, or invited to after-work outings to strip clubs.

Under traditional tort doctrines, employers can be held liable for an employee's sexual harassment of another person. The Supreme Court has held that employers can overcome this liability by demonstrating that they conduct workplace training about sexual harassment and have implemented policies, including methods for employees to report suspected cases of harassment, and that they take prompt action against any employee found to be engaging in sexual harassment. *Burlington Industries, Inc. v. Ellerth*, 524 U.S. 742 (1998). The Supreme Court has also held that men can be the victims of sexual harassment and that same-sex sexual harassment is also illegal under Title VII. *Oncale v. Sundowner Offshore Services*, 523 U.S. 75 (1998). The hostile work environment theory is not limited to discrimination on the basis of sex; a hostile work environment can also be motivated by discrimination on the basis of race, color, national origin, religion, age, and disability.

Key Takeaways

Racial discrimination charges are the most common form of complaint filed with the EEOC. Discrimination on the basis of race or color prohibits employers from adopting any policy or practice that has a disparate impact on persons because of their race or color. To be legal, job policies or practices that have a disparate impact on protected classes must be related to the job function and qualify as a business necessity. Discrimination on the basis of national origin (ethnicity, accent, or language) is illegal. Discrimination on the basis of religion is also illegal. Employers must reasonably accommodate an employee's religious beliefs unless doing so would pose an undue hardship on the employer's operation of business. Discriminating against someone because of his or her sex is illegal. It is also illegal to treat primary caregivers differently because they are male or female. Finally, workplace harassment is illegal if it is severe and pervasive and alters the conditions of an employee's employment.

? Exercise 5.3.1

1. If a Jewish or Muslim worker asked for halal or kosher food in the employee cafeteria, should an employer accommodate this request? Why or why not? What factors do you think the employer should consider before making a decision?
2. In many countries it is common for résumés to contain photos of the job applicants. It is also common to classify jobs by sex (i.e., a job posting for a female secretary or male forklift driver). What do you believe the United States has gained or lost by moving away from this system of job applicant screening?
3. Do you believe that the school bus driver in Minnesota should be permitted to refuse driving a bus if it carries an advertisement that the driver believes promotes immoral lifestyles? Why or why not? Should a vegetarian driver be permitted to refuse to drive a bus with an advertisement for hamburgers? Should a Post Office delivery person be permitted

to refuse to deliver copies of *Playboy* magazine on the same grounds?

4. Can you think of any jobs where speaking English without an accent may be very important or essential?

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5.4: Other Federal Antidiscrimination Laws

Learning Objectives

- Explore the 1866 Civil Rights Act.
- Learn about the Equal Pay Act.
- Understand the Age Discrimination in Employment Act.
- Study the Americans with Disabilities Act.

While the 1964 Civil Rights Act is the most important federal civil rights law, it isn't the only basis for employment discrimination. Protections also exist to protect women against unequal pay, pregnant women, workers older than forty, and people with disabilities. In this section, we'll examine these other statutes.

The first statute is the 1866 Civil Rights Act. It was passed after the Civil War to guarantee freed slaves the rights of citizenship, and it is still in force today. It prohibits discrimination on the basis of race, including private discrimination. The 1866 Civil Rights Act provides victims of race discrimination several advantages over Title VII. Unlike Title VII, victims do not need to file a complaint with the Equal Employment Opportunity Commission (EEOC) first—they can go straight to federal court to file a complaint. In addition, the strict filing deadlines under Title VII do not apply. Finally, the statutory limits on punitive damages under Title VII do not apply, so higher damages are possible under the 1866 Civil Rights Act. Unlike Title VII, however, the 1866 Civil Rights Act only prohibits racial discrimination. In most race discrimination cases, plaintiffs file both Title VII claims and claims under the 1866 Civil Rights Act. These are commonly known as Section 1983 claims, named after the section of the U.S. statute that allows victims of race discrimination to file their complaints in federal court.

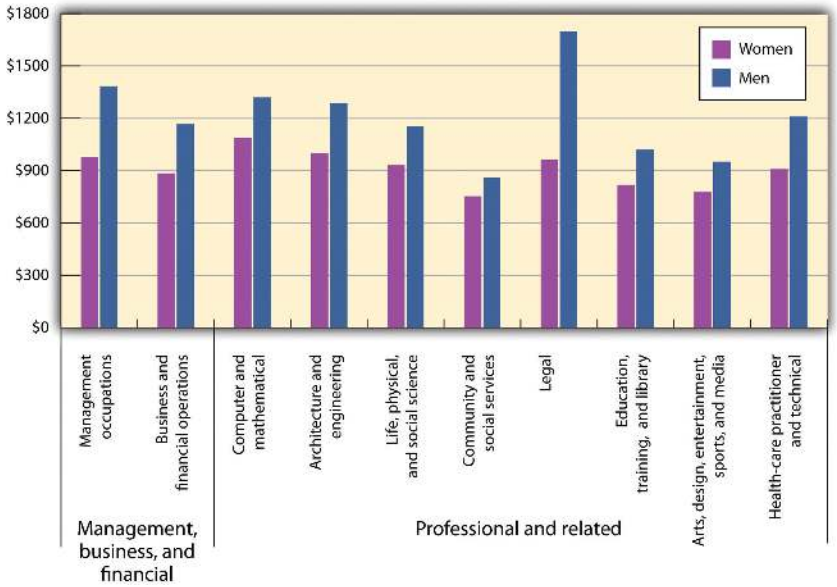


Figure 5.4.1: Median Weekly Earnings of Women and Men in Management, Professional, and Related Occupational Groups, 2008. Women still make less than their male counterparts across all industries. Source: Adapted from U.S. Bureau of Labor Statistics, "Women and Men in Management, Professional, and Related Occupations, 2008," August 7, 2009, http://bls.gov/opub/ted/2009/ted_20090807.htm (accessed September 27, 2010).

The Equal Pay Act of 1963 seeks to eliminate the wage gap between women and men. In 1970 women earned roughly sixty-two cents for every dollar men earned. In 2004 that number had climbed to eighty cents. In 2008 women still earn less than their male counterparts in all sectors of the economy, as the chart from the Bureau of Labor Statistics demonstrates (Figure 12.4.1 "Median Weekly Earnings of Women and Men in Management, Professional, and Related Occupational Groups, 2008"). The Equal Pay Act demands that employers provide equal pay for equal work, and it applies to all employers. All forms of compensation are covered by the act, including benefits such as vacation and compensation such as salary and bonus. Victims do not need to file a complaint with the EEOC under the Equal Pay Act, but may instead go straight to federal court, as long as they do so within two years of the

alleged unlawful employment practice. Victims typically also pursue Title VII claims at the same time they pursue Equal Pay Act claims.

The Equal Pay Act is very difficult to enforce. Since demanding identical pay is virtually impossible due to differences in jobs and job performance, courts have essentially interpreted the law as requiring substantially equal pay for substantially equal work. Courts are extremely reluctant to get into the business of telling employers what they should pay their workers. In 2009 the EEOC received fewer than one thousand complaints about unequal pay nationwide, or less than 1 percent of the charges filed.U.S. Equal Employment Opportunity Commission, "Charge Statistics FY 1997 through FY 2009," http://eeoc.gov/eeoc/statistics/enforcement/charges.cfm (accessed September 27, 2010).

Hyperlink: Despite New Law, Gender Salary Gap Persists

http://www.npr.org/templates/story/story.php?storyId=125998232

In some part, women make less money than men because they voluntarily leave the workforce to raise children, or because women are directed to occupations with traditionally less pay. Even if these factors are eliminated, however, there is still a pay gap between women and men. This gap grows over time, leaving women with hundreds of thousands less at the end of a career when compared with a male's comparable career. Now, Congress is considering new legislation to address the problem in the Paycheck Fairness Act, as this NPR story explains.

The Pregnancy Discrimination Act of 1978 amended Title VII to make it illegal to discriminate on the basis of pregnancy, childbirth, or related medical conditions. This means employers cannot refuse to hire a woman because she is pregnant or is considering becoming pregnant, or because of prejudices held by coworkers or customers about pregnant women. A female worker who becomes pregnant is entitled to work as long as she can perform her tasks, and her job must be held open for her while she is on maternity leave. Furthermore, pregnancy-related benefits cannot be limited only to married employees.

The Age Discrimination in Employment Act of 1967 (ADEA) makes it illegal to discriminate against workers over the age of forty. It does not protect younger workers, who are of course subject to a form of discrimination every time they are told an employer is looking for someone with more experience. The ADEA applies to any employer with over twenty workers, including state governments. Partnerships such as law firms and accounting firms are also covered under the ADEA. In 2007 a major law firm, Sidley Austin, agreed to pay $27.5 million to former partners the firm had terminated because of their age, resulting in a median payout of over $875,000 per terminated partner.U.S. Equal Employment Opportunity Commission, "$27.5 Million Consent Decree Resolves EEOC Age Bias Suit against Sidley Austin," October 5, 2007, http://www.eeoc.gov/eeoc/newsroom/release/10-5-07.cfm (accessed September 27, 2010). The ADEA prohibits employers from treating any covered person unfavorably in any term or condition of employment, including the hiring decision. It is illegal, for example, to hire an inexperienced twenty-five-year-old for a job when a fifty-year-old is better qualified and willing to work for the same conditions. An employer may, however, favor an older worker over a younger worker even if the younger worker is over forty years of age. Mandatory retirement age is illegal under the ADEA, except for very high-level executives over the age of sixty-five who are entitled to a pension.

Employers should be very careful about asking for a job applicant's date of birth during the application process, as this might be a sign of possible discriminatory intent. Employers may discriminate against older workers if there is a bona fide occupational qualification (BFOQ), such as a production company casting for a young actor to play a young character, or airlines setting a mandatory retirement age for pilots.

Of course, older workers can still be dismissed for good cause, such as poor job performance or employee misconduct. Companies may also administer a layoff plan or early retirement plan that is evenly applied across all workers, and can offer early retirement incentives to induce workers to retire. Typically when companies ask a worker to retire early or take an incentive to leave the company, the worker is asked to sign an ADEA waiver, giving up any claims the worker may have under the ADEA. These waivers are fully enforceable under the ADEA as long as they are "knowing and voluntary," in writing, and provide the worker with at least twenty-one days to consider the waiver and seven days to revoke it after signing it.

Although it was passed around the same time as Title VII, for decades courts held that only disparate treatment cases under the ADEA were viable. That meant plaintiffs had to find proof of intentional discrimination to recover, so there were relatively few successful age discrimination cases. To make matters even harder for older workers, in 2009 the Supreme Court held that older

workers suing under the ADEA had to prove that their age was a "but-for" reason for their termination, or the sole cause for termination. *Gross v. FBL Financial Services*, 557 U.S. ___ (2009), http://www.law.cornell.edu/supct/html/08-441.ZS.html (accessed October 2, 2010). This makes age discrimination much harder to prove than discrimination because of sex or race, where illegal discrimination only has to be one of several factors that motivated the employer. In fact, the 2009 decision made it all but impossible for older workers to prove intentional discrimination, and congressional efforts to overturn the decision in the form of the Protecting Older Workers Against Discrimination Act are pending.

In 2005 the Supreme Court held that the disparate impact theory can apply to age discrimination cases. *Smith v. City of Jackson*, 544 U.S. 228 (2005). For example, an employer cannot require office workers to undertake strenuous physical tests if those tests are not related to the job being performed and would have a disparate impact on older workers. Rather than open the floodgates to ADEA litigation, however, the ensuing years saw relatively little increase in ADEA-related litigation. One reason may be that the Court emphasized that the ADEA contains a unique defense for employers not present in Title VII: employers are allowed to take unfavorable action against older workers for "reasonable factors other than age" (RFOA). In the 2005 case, a city had decided to give larger pay increases to younger workers compared to older workers, for the stated reason that the city wanted to make pay for younger workers competitive with the market. The Supreme Court found this explanation reasonable. In 2010 the EEOC published a proposed rule to clarify the meaning of "reasonable factors." The proposed rule would allow neutral policies that negatively affect older workers only if the policy is "objectively reasonable when viewed from the perspective of a reasonable employer under like circumstances."U.S. Equal Employment Opportunity Commission, "EEOC Solicits Comments on Proposed Rule concerning 'Reasonable Factors other than Age' under the ADEA," February 18, 2010, http://www.eeoc.gov/eeoc/newsroom/release/2-18-10.cfm (accessed September 27, 2010). If the proposed rule is adopted, it would make it much more difficult for employers to rely on "reasonable factors" as a defense to an age discrimination claim.

After the major laws of the 1960s were passed, Congress did very little to protect civil rights in the workplace for many years. This changed in 1990, when Congress passed a major new piece of legislation known as the Americans with Disabilities Act of 1990 (ADA), signed into law by President George H. W. Bush. With passage of the ADA, Congress sought to expand the promise of equal opportunity in the workplace to cover persons with disabilities. Unfortunately, the ADA was less than clear in many critical aspects when it was written, leaving courts to interpret what Congress may have meant with specific ADA language. An increasingly conservative judiciary, including the Supreme Court, began interpreting the ADA fairly narrowly, making it harder for people with disabilities to win their court cases. Congress responded with the Americans with Disabilities Amendments Act of 2008 (ADAA), signed into law by President George W. Bush, which specifically overturned several key Supreme Court decisions to broaden the scope of the ADA.

The ADA is broken down into several titles. Title III, for example, deals with requirements for public accommodations such as wheelchair ramps, elevators, and accessible restrooms for new facilities. Title II deals with the ADA's applicability to state and local governments. For employees, the most important provisions are located in Title I, which makes it illegal for employers with fifteen or more employees to discriminate against "qualified individuals with disabilities."

It is a common misconception that the ADA requires employers to hire disabled workers over able-bodied workers. This is simply not true because the ADA only applies to the qualified disabled. To be qualified, the individual must meet the legitimate skill, experience, education, or other requirements for the position he or she is seeking and be able to perform the "essential functions" of the job without reasonable accommodation. In other words, the first step an employer must take is to define what the essential functions of the job are, and then see if a disabled individual who has applied for the job meets the requirements for the job and can perform those essential functions. Obviously, someone who is legally blind will not be permitted to be a bus driver or airline pilot under this test. Similarly, a paraplegic will not be qualified to work as a forklift operator since that person will be unable to perform the essential functions of that job without reasonable accommodation. On the other hand, the "essential functions" test means that employers must be very careful in denying employment to someone who is disabled. If the reason for denying employment is the disabled person's inability to perform some incidental task (rather than an essential function), then that is illegal discrimination. The ADA also permits employers to exclude any disabled individual who poses a direct threat to the health or safety to the individual or of others, if the risk of substantial harm cannot be reduced below the level of "direct threat" through reasonable accommodation.

The ADA makes it illegal for an employer to require a job applicant take a medical exam before an employment offer is made. However, after a job offer has been made, applicants can be asked to take medical and drug exams. Tests for illegal use of drugs,

any time during employment, are permitted under the ADA.

One of the most vexing questions faced by employers is in defining who is disabled. The ADA states that an individual is disabled if he or she has a "physical or mental impairment that substantially limits one or more major life activities," has a record of such impairment, or is regarded as having such an impairment. Major life activities include seeing, hearing, speaking, walking, running, breathing, learning, and caring for oneself. For example, consider a person being actively treated for cancer. During the treatment, many major life activities may be substantially limited, so the person is disabled. However, if a major life activity is not limited but the person loses his or her hair as a result of chemotherapy, he or she may be "regarded" as having an impairment, which makes him or her disabled under the ADA. An employer who purposefully refuses to hire a qualified job applicant with no hair because the employer believes the applicant has cancer (regardless of whether the cancer is active or in remission) is, therefore, violating the ADA. Finally, if the cancer patient recovers fully and has no physical sign of cancer, that patient is still considered protected by the ADA because he has a "record" of a qualifying disability.

After the ADA's passage in 1990, the Supreme Court began confronting the meaning of these terms in a series of cases. In one case, the Court held that anyone with a disability that could be mitigated or corrected was no longer disabled under the ADA. *Sutton v. United Airlines*, 527 U.S. 471 (1999). This decision led to uproar and controversy. By narrowing the definition of who was disabled, the Court made it very hard for disabled persons to prove discrimination. A diabetic who can control the disease with insulin, for example, was not disabled under this definition. Therefore, an employer who fired a diabetic for taking breaks to inject insulin was not violating the ADA. The ADAA specifically overturns this case, and now employers are prohibited from considering mitigating measures such as medication or technology when determining whether or not a major life activity is substantially limited. The ADAA does carve out one exception: anyone with poor vision that is correctable with glasses or contact lenses is not disabled under the ADA.

In another case limiting the definition of who is disabled, the Court held that a physical or mental impairment must have a substantial effect on an employee's daily life, not just that person's ability to perform his or her specific job. *Toyota Motor Manufacturing v. Williams*, 534 U.S. 184 (2002). This case has also been overruled by the ADAA, which directs the EEOC to issue new guidelines that are much more liberal in interpreting the meaning of what it means to substantially limit a major life activity.

Under the new ADAA and EEOC guidelines, a list of impairments that substantially limit a major life activity that will "consistently" result in a disability determination might include blindness, deafness, intellectual disability, missing limbs, mobility impairments requiring the use of a wheelchair, autism, cancer, cerebral palsy, diabetes, epilepsy, HIV/AIDS, multiple sclerosis, muscular dystrophy, major depression, bipolar disorder, posttraumatic stress disorder, obsessive compulsive disorder, and schizophrenia.U.S. Equal Employment Opportunity Commission, "Summary of Key Provisions: EEOC's Notice of Proposed Rulemaking (NPRM) to Implement the ADA Amendments Act of 2008 (ADAA)," http://www.eeoc.gov/laws/regulations/adaaa-summary.cfm (accessed September 27, 2010). Other impairments that may require more analysis to determine if they substantially limit an individual's major life activities include asthma, high blood pressure, back and leg impairments, learning disabilities, panic or anxiety disorders, some forms of depression, carpal tunnel syndrome, and hyperthyroidism. The impairment cannot be temporary or nonchronic (such as the common cold, seasonal influenza, sprained joint, minor gastrointestinal disorders, seasonal allergies, broken bones, and appendicitis). However, an impairment that is episodic such as epilepsy or cancer would qualify if it limits a major life activity while it is active. Pregnant women are generally not considered disabled, although of course other civil rights statutes, such as Title VII, may protect them. Note that while current illegal drug users are not considered disabled, alcoholics may be considered disabled if the disease substantially limits a major life activity.

Although an employer is not required to hire the unqualified disabled, if it does hire a disabled individual it must provide reasonable accommodation to any disabled worker who asks for it. Reasonable accommodation is any change or adjustment to the work environment that would allow the disabled worker to perform the essential functions of the job or to allow the disabled worker to enjoy the benefits and privileges of employment equal to employees without disabilities. Reasonable accommodation might include allowing the worker to work part-time or modified work schedules; reassigning the worker to a vacant position; purchasing special equipment or software; providing readers or interpreters; or adjusting or modifying exams, training materials, and policies. Employers do not have to undertake reasonable accommodation if doing so would cause them undue hardship, meaning it would require significant difficulty or expense, or significantly alter the nature or operation of the business. Among factors to be considered in whether an accommodation would pose an undue hardship are the cost of the accommodation as well as the employer's size and financial resources.

Key Takeaways

The 1866 Civil Rights Act prevents private discrimination on the basis of race, and provides a quick route for victims of racial discrimination to federal court without following procedural gateways established by the EEOC. The Equal Pay Act requires employers to pay men and women substantially equal pay for substantially equal work, but it is very difficult to enforce. Title VII also protects pregnant women from workplace discrimination. The Age Discrimination in Employment Act prohibits discrimination against workers over the age of forty. The BFOQ defense is available for age discrimination claims, as well as taking adverse action for a reasonable factor other than age. The Americans with Disabilities Act prohibits employment discrimination against the qualified disabled and prohibits preemployment medical testing. To be considered disabled, an individual must demonstrate a mental or physical impairment that substantially limits a major life activity. Disabled persons are entitled to reasonable accommodation in the workplace, as long as reasonable accommodation does not place any undue hardship on the employer.

? Exercise 5.4.1

1. The Equal Pay Act of 1963 is decades old, but women have still not closed the gap with men when it comes to pay. Why do you think this is? Do you believe Congress can play a role in closing this gap?
2. The number of age-related claims filed with the EEOC has increased steadily, from 19.6 percent of cases filed in 1997 to 24.4 percent of cases filed in 2009. Why do you think this number is increasing?
3. Think about the job that you would like most to have when you graduate college. What do you think the "essential functions" of that job are? What sorts of disabilities do you think would disqualify you or someone else from performing those essential functions?
4. Do you believe that alcoholics should be considered disabled under the ADA? Why or why not?
5. A person with a lifetime allergy to peanuts is probably disabled under the ADA, but a person with seasonal allergies to pollen is not. Does this distinction make sense to you? Why or why not?

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5.5: Concluding Thoughts

Most people find the idea of being judged based on the basis of an “immutable” characteristic such as race, color, or sex grossly unfair. We wish to be judged on the basis of our merit and character, things that we can control. The same is true in the workplace, where most people hold firm to the belief that the hardest working, smartest, and most business-savvy should succeed. Employment discrimination law is meant to address this ideal, but like all laws, it can be a blunt instrument where sometimes a finer approach is called for.

Hyperlink: A Class Divided

http://www.pbs.org/wgbh/pages/frontline/shows/divided

On the morning after Martin Luther King Jr. was assassinated, Jane Elliott, a third-grade teacher in an all-white elementary school in Iowa, divided her class into two groups: those with brown eyes and those with blue eyes. It was 1968, four years after Title VII, and the country was still torn by racial discrimination. What Jane Elliott found out that day about the nature of discrimination and the lessons her students took with them after the experiment was over are the subject of this *Frontline* documentary.

In many ways, the debates surrounding what kind of protections against discrimination Americans should enjoy in the workplace mirror larger debates about the role of government in ensuring the equal protection of the laws for its citizens. Since the laws in this area are notoriously difficult to interpret, it falls on judges and juries to decide when illegal discrimination has taken place. Unfortunately for plaintiffs, the result is often less than justice.

It is hard to prove an employment discrimination case, under either disparate treatment or disparate impact cases. For example, the Equal Employment Opportunity Commission (EEOC) collects statistics for each type of charge filed with the commission and how the case is resolved. In 2009, for race-based charges, 66 percent resulted in a finding of “no reasonable cause,” meaning the EEOC found no evidence of discrimination.U.S. Equal Employment Opportunity Commission, “Race-Based Charges FY 1997–FY 2009,” http://eeoc.gov/eeoc/statistics/enforcement/race.cfm (accessed September 27, 2010). For religion-based charges, 61 percent resulted in a finding of “no reasonable cause.”U.S. Equal Employment Opportunity Commission, “Religion-Based Charges FY 1997–FY 2009,” http://eeoc.gov/eeoc/statistics/enforcement/religion.cfm (accessed September 27, 2010). The proof necessary to win these cases, as well as the reluctance of plaintiffs to come forward when they might be reliant on the employer for a continuing paycheck, mean that many instances of illegal discrimination go unreported. Often, those being discriminated against are among vulnerable populations with no independent means of living if they lose their jobs. To top it off, the low success rates mean that attorneys in employment discrimination cases rarely take their cases on contingency, so victims have to pay expensive hourly fees. The rise of predispute arbitration clauses in the employment setting also means that workers facing illegal discrimination face a huge chasm between the promise of equality under the law and the reality of pursuing that promise.

As we move into the twenty-first century, new workplace discrimination issues will continue to surface. There is already widespread concern about the use of genetic information found in DNA to discriminate against employees because of the chances they might get a certain disease. This concern led to the passage of the Genetic Information Nondiscrimination Act of 2008. In spite of legislative action, however, too many cases of illegal discrimination are still taking place in the workplace. Adequately addressing this injustice will ultimately fall on a new generation of business leaders, such as you.

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CHAPTER OVERVIEW

6: Alternative Dispute Resolution

6.1: Introduction
6.2: Negotiation
6.3: Mediation
6.4: Arbitration
6.5: Other Methods of Alternative Dispute Resolution
6.6: Public Policy, Legislation, and Alternative Dispute Resolution
6.7: Concluding Thoughts

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6.1: Introduction

Learning Objectives

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

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

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

A common method of dispute resolution that avoids many of the challenges associated with litigation is alternative dispute resolution. Alternative dispute resolution (ADR) is a term that encompasses many different methods of dispute resolution *other than* litigation. ADR involves resolving disputes outside of the judicial process, though the judiciary can require parties to participate in specific types of ADR, such as arbitration, for some types of conflicts. Moreover, some ADR methods vest power to resolve the dispute in a neutral party, while other strategies vest that power in the parties themselves. See Figure 4.1.1 "A Continuum of Different ADR Methods" for a continuum of different ADR methods based on where power to solve the dispute is vested.

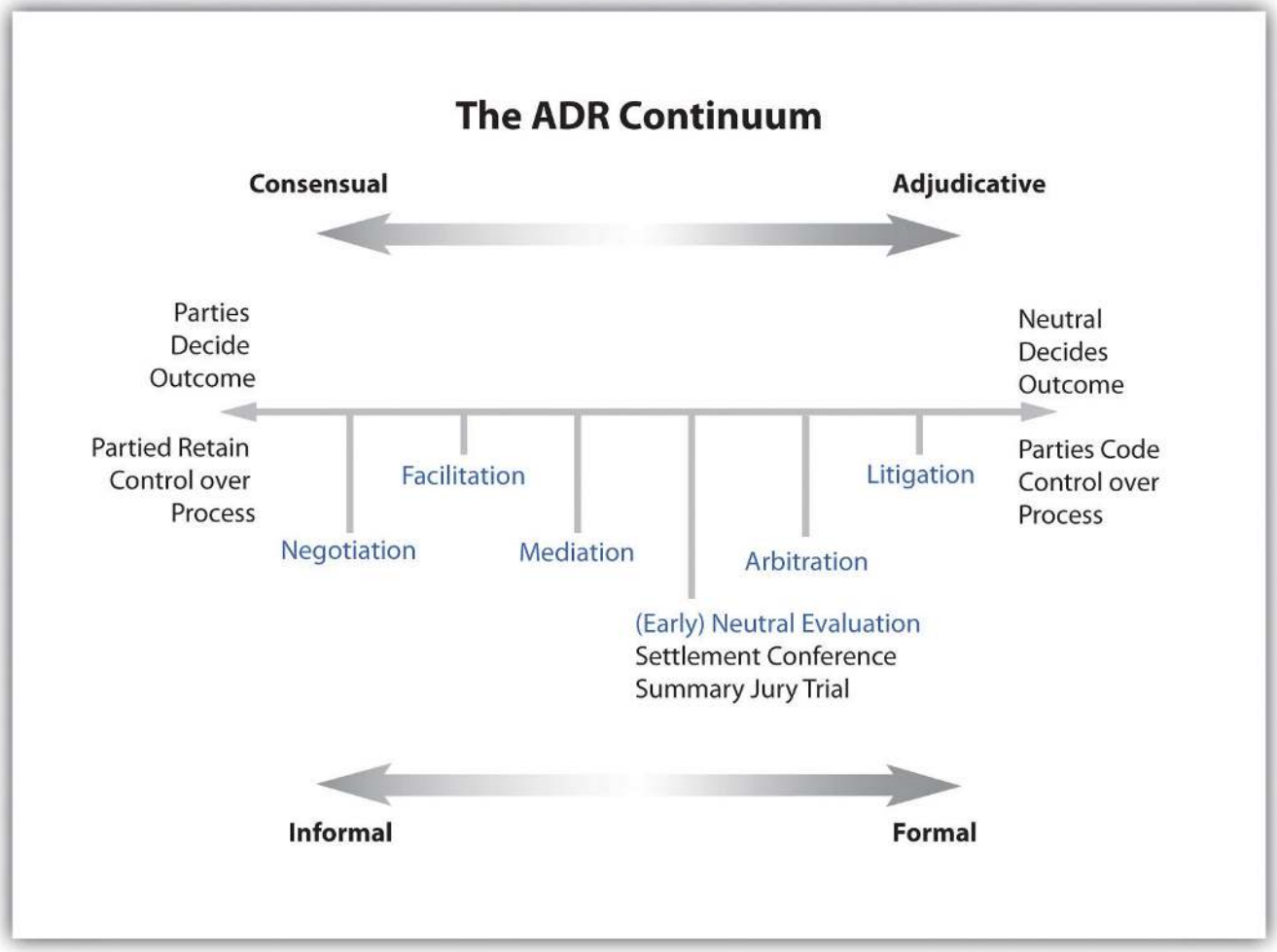


Figure 6.1.1: A Continuum of Different ADR Methods. Source: Adapted from New York State Unified Court System, www.nycourts.gov/ip/adr/images/continuum2.jpg.

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

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

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

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

Key Takeaways

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

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6.2: Negotiation

Learning Objectives

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

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

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

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

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

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

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

Hyperlink: Rubbermaid's Unequal Bargaining Power

A Question of Ethics

http://www.pbs.org/wgbh/pages/frontline/video/flv/generic.html?s=frol02s48aq71&continuous=1

Watch "Muscling Manufacturers," a clip from *Is Wal-Mart Good for America?* to see how unequal bargaining power can affect the least powerful party in a negotiation.

As economist Brink Lindsey from the Cato Institute commented, "We've definitely seen a shift in the balance of bargaining power between manufacturers and retailers…Back in the old days, manufacturing was a high-productivity endeavor; retailing and distribution was fairly low-productivity…And so manufacturers called the shots."Hedrick Smith, "Who Calls the Shots in the Global Economy?" *PBS*, November 16, 2004, http://www.pbs.org/wgbh/pages/frontline/shows/walmart/secrets/shots.html (accessed on August 23, 2010).

That doesn't appear to be the case anymore.

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

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

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

Key Takeaways

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

Exercise 6.2.1

1. Visit www.sfhgroup.com/ca/training/online-training/test-your-skills.php and click “Negotiate with Bill” under “Online Negotiation Course.” This is a free interactive negotiation exercise. After completing the negotiation, answer the following questions: How far did you get? (If you did not get to level three, go back and try it again. See if you can get all the way through to level three.) What negotiation strategies did you learn? In other words, what works? What doesn’t work?
2. What are the benefits of negotiation as a dispute-resolution method? What are the drawbacks?
3. How can parties that have unequal bargaining power negotiate meaningfully, without one party taking advantage of the other? Have you ever negotiated with someone who had more bargaining power than you? What were your strategies during the negotiation? Did you obtain your goal by the conclusion of the negotiation?
4. Watch the video in "Hyperlink: Rubbermaid’s Unequal Bargaining Power". If you were a manufacturer and you had to raise prices due to an increase in price for your raw materials, and if Wal-Mart was your most important customer, what strategies would you employ so that both parties would have a chance to have a “win-win” outcome?

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6.3: Mediation

Learning Objectives

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

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

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

Hyperlink: Mediators

http://www.mediationworks.com/medcert3/staterequirements.htm

Visit this site to see the various requirements and qualifications to become a mediator in the different states.

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

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

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

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

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

Key Takeaways

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

? Exercise 6.3.1

1. Visit the link in "Hyperlink: Mediators" and find your state's requirements and qualifications for mediators. What would it take for you to become a mediator in your state? Do you think that your state requirements ensure that only qualified mediators practice? Why or why not?
2. Identify a situation in which you would choose mediation as your preferred method of dispute resolution. Why is mediation the best method in this situation? What are the potential benefits and drawbacks of mediation in this situation?
3. Should mediators be required to be licensed, like attorneys or physicians, before practicing? Why or why not?
4. Visit www.sfhgroup.com/ca/training/online-training/test-your-skills.php and scroll down to Mediation game. Click on "play game" under "The Angry Neighbours." This is a free interactive mediation exercise. After completing the mediation, answer the following questions: Were you able to successfully mediate this dispute? If you did not reach a successful resolution, go back and try it again. See if you can reach a successful resolution. What mediation strategies did you learn? What works? What doesn't work?

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6.4: Arbitration

Learning Objectives

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Additionally, some types of disputes that have been subjected to mandatory arbitration raise serious questions about the appropriateness of ADR, due to the nature of the underlying dispute. For example, in some recent B2E disputes, claims relating to sexual assault have been subjected to mandatory arbitration when the employee signed an employment contract with a mandatory arbitration clause. Tracy Barker, for example, was reportedly sexually assaulted by a State Department employee in Iraq while she was employed as a civilian contractor by KBR Inc., a former Halliburton subsidiary. When she tried to bring her claim in court, the judge dismissed the claim, citing the mandatory arbitration clause in her employment contract. After arbitration, she won a three-million-dollar arbitration award. As KBR Inc. noted, this "decision validates what KBR has maintained all along; that the arbitration process is truly neutral and works in the best interest of the parties involved." Despite this statement, KBR Inc. has filed a motion to modify the award. Juan A. Lozano, "Woman Awarded $3M in Assault Claim against KBR," *AP News*, November 19, 2009, www.thefreelibrary.com/Woman+awarded+%243M+in+ assault+claim+against+KBR-a01612064743 (accessed September 24, 2010).

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

Video Clip: Al Franken

Watch Senator Al Franken discuss the facts of the Jamie Leigh Jones case here:

(click to see video)

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

Hyperlink: Arbitration

www.citizen.org/documents/ArbitrationDebateTrap(Final).pdf

Check out this Public Citizen report, *The Arbitration Debate Trap: How Opponents of Corporate Accountability Distort the Debate on Arbitration*, which argues arbitration is bad for consumers in B2C disputes.

Importantly, and despite the FAA's broad interpretation, not all binding arbitration clauses have been upheld by courts in B2C cases. In 2007, the Ninth Circuit Court of Appeals ruled that AT&T's binding arbitration clause for wireless customers is unenforceable under California state law. *Lozano v. AT & T Wireless*, 504 F.3d 718 (9th Cir. 2007). The court further noted that the relevant state law is not preempted by the FAA, because the FAA does not prevent the courts from applying state law. In this case, that law involved unconscionability of contract terms. As noted previously, the FAA requires parties to submit to mandatory arbitration when they agree to do so in a legally binding contract, and it preempts state powers to provide a judicial forum in those matters. However, the Ninth Circuit's holding in this case underscores the fact that state contract law is not circumvented by the federal statute.

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

Key Takeaways

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

? Exercise 6.4.1

1. Check out Jon Stewart's perspective on Senator Franken's proposed measure to prevent the Department of Defense from contracting with defense contractors that require mandatory arbitration for disputes arising from sexual assaults at http://www.thedailyshow.com/watch/wed-october-14-2009/rape-nuts. Does the comedian accurately portray this issue? What role does popular culture have in shaping our opinions and conceptions of our legal system?
2. In the *Barker v. Halliburton Inc*. case, does the three-million-dollar arbitration award in favor of the sexual assault victim prove that arbitration works, even in violations of civil rights disputes? Why or why not?
3. Choose one argument in *The Arbitration Debate Trap: How Opponents of Corporate Accountability Distort the Debate on Arbitration* in "Hyperlink: Arbitration" and develop a counterargument to support the contention that arbitration *is* good in B2C disputes. Compare your argument with the argument in the report. Which side is the most persuasive? After completing this exercise, do you believe that arbitration is good or bad for consumers in B2C disputes? Why?
4. Bank of America announced that it would no longer require mandatory arbitration in disputes arising between it and consumer credit card account holders. Review the story here: http://www.reuters.com/article/idUSTRE57D03E20090814. What are the benefits and drawbacks to Bank of America's credit card account customers with respect to this change?
5. In what contexts have you entered into an arbitration agreement (e.g., home purchase, credit card agreement, cell phone agreement)? Write a short essay discussing the implications of entering into that agreement.

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6.5: Other Methods of Alternative Dispute Resolution

Learning Objectives

- Learn about in-house dispute-resolution methods, med-arb, private judging, minitrials, and summary jury trials.
- Explore the benefits and drawbacks to forms of alternative dispute resolution (ADR) discussed in this section.

Remember that ADR is a broad term used to denote methods to resolve disputes outside of litigation. This can really be any method, whether or not it bears a specific label or adheres to a particular procedure. For instance, negotiation might be a quick meeting in the hallway between disputants, or it might involve a formal round of negotiations where all parties are represented by legal counsel.

However, when parties are attempting to resolve a dispute, it makes sense for them to agree to a specific procedure for doing so beforehand, so that each party understands how to proceed. Negotiation, mediation, and arbitration are the most common forms of ADR. However, these methods might not be appropriate for every dispute. Other forms of ADR exist, ranging from in-house programs to very formal external processes. This section briefly discusses commonly used alternatives to resolving disputes besides negotiation, mediation, arbitration, or litigation.

Some ADR processes or programs are available only to certain groups of people, such as members of a particular organization. For instance, some organizations, like Boeing, have an internal ethics hotline. This hotline is available for employees to report perceived ethics violation that they have observed. Ethics advisors answer employees' questions and follow up on reports that need further investigation. One major benefit is that reporting parties generally (but not always) remain anonymous. Another benefit is that the company has time to redress problems that could give rise to disputes of much greater magnitude if left unaddressed.

An open-door policy is an in-house program that allows company employees to go directly to any level of management to file a complaint or grievance, without threat of retaliation for their reporting. In theory, this policy creates an open atmosphere of trust, and it breaks down class barriers between groups of employees. However, many employees may not feel comfortable in making a complaint about a manager's decision. Moreover, supervisors may not be comfortable with their employees bypassing them to file complaints. Open-door policies sound very good in theory, but they may not work as well in practice.

Another type of in-house program is an ombudsmen's office. These stations generally hear complaints from stakeholders, such as employees or customers. Ombudsmen try to troubleshoot these complaints by investigating and attempting to resolve the issues before they escalate into more formal complaints.

More formal methods of ADR include mediation-arbitration (med-arb), which is essentially a mediation followed by an arbitration. If the mediation does not produce a satisfactory outcome, then the parties submit to arbitration. The neutral party mediating the dispute also serves as the arbitrator if the dispute-resolution process goes that far. Med-arb has the same benefits and drawbacks as mediation and arbitration alone, with some important differences. For instance, parties in a med-arb know that their dispute will be resolved. This is unlike mediation alone, where parties may walk away if they do not think that the mediation is serving their interests. Moreover, the parties in med-arb have an opportunity to reach a win-win outcome as in mediation. However, if they do not reach a satisfactory outcome, then one party will "win" and one party will "lose" during the arbitration phase. The knowledge that an arbitration will definitely follow a failed mediation can be a strong incentive to ensure that the mediation phase of a med-arb works.

Private judging, contemplated by many state statutes, is a process in which active or retired judges may be hired for private trials. Private judging is essentially private litigation. The hired judge can preside over a private trial that is not truncated by limits on discovery or abbreviated rules of procedure, as would be the case in arbitration. Additionally, the judge who oversees the process is highly experienced in such matters as evidence and decision rendering. Moreover, the parties who can afford to pay for this service have a substantial benefit in not having to wait to have their cases heard in the public court. The private trial is also private rather than public, which may be important to parties who require confidentiality. In states where statutes permit hiring a judge for such matters, the parties' ability to appeal is often preserved. Drawbacks include the sometimes questionable nature of enforceability of judgments rendered, though some state statutes allow enforceability of those judgments as if they were issued in public court. Moreover, this system may benefit those who can afford to pay for this service, while others must wait for their case to appear on

the docket in public court. This raises questions of fairness. See "Hyperlink: Private Judges" for one state's frequently asked questions (FAQ) regarding private judges.

Hyperlink: Private Judges

www.in.gov/judiciary/admin/private-judges/faq.html

Check out Indiana Courts' Web page with frequently asked questions about private judges.

Does your state permit private judging?

A minitrial is a procedure that allows the parties to present their case to decision-makers on both sides of the dispute, following discovery. This is a private affair. After the cases are presented, the parties enter into mediation or negotiation to resolve their dispute.

A summary jury trial is a mock trial presented to a jury whose verdict is nonbinding. The presentation is brief and succinct, and it follows a discovery period. The jury does not know that its verdict will be advisory only. This process allows parties to measure the strengths and weaknesses of their cases prior to engaging in litigation, which presumably saves both time and money. After the minitrial, parties are in a better position to negotiate or mediate an outcome that fairly represents their positions.

Key Takeaways

Methods of ADR other than negotiation, mediation, and arbitration are available to disputants. For example, minitrials, med-arb, private judging, and summary jury trials are common alternatives, as are in-house programs like ombudsmen, anonymous ethics hotlines, and open-door policies. Benefits and drawbacks to these methods exist relative to other methods of ADR and to litigation.

Exercise 6.5.1

1. Visit Boeing's Ethics Line Web page: www.boeing.com/companyoffices/aboutus/ethics/hotline.html. Do you think this program can address all disputes before they get out of hand? Why or why not? What type of dispute might not be appropriate to bring to an ethics hotline program?
2. Locate two "ethics hotline" programs from an online search. Compare these programs. What are the benefits and drawbacks to each?
3. Check out "Hyperlink: Private Judges". Do you think that people should be permitted to hire judges to preside over private trials if they can afford to do so? What benefits to litigants in a private trial have over litigants in a public trial? What ethical issues exist with respect to private judges?
4. Why would a party choose med-arb over mediation or arbitration alone?

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6.6: Public Policy, Legislation, and Alternative Dispute Resolution

Learning Objectives

- Explore potential restrictions upon ADR.
- Review points of access to government to change public policy.
- Examine the Arbitration Fairness Act Bill.

Alternative dispute resolution can be a very useful alternative to litigation. There are many advantages to disputants, such as expediency, cost savings, and greater privacy than litigation. In business to business (B2B) disputes, alternative dispute resolution (ADR) often makes sense.

The Federal Arbitration Act (FAA) is a federal statute that the U.S. Supreme Court interpreted as a national policy favoring arbitration in *Southland Corp. v. Keating*.*Southland Corp. v. Keating*, 465 U.S. 1 (1984). According to the *Southland Corp* Court, state power to create judicial forums to resolve claims when contracting parties enter into a mandatory arbitration agreement has been preempted by the FAA. However, not all disputes are well suited for ADR. This is an area in which Congress could make substantial changes in public policy through the creation of new law, to ensure fairness between unequal parties and to ensure the protection of civil rights. Congress could do this by making ADR optional, rather than mandatory, for some types of disputes. It could exclude certain types of disputes from being bound to arbitration through mandatory arbitration clauses.

For example, the proposed Arbitration Fairness Act of 2009 (AFA) would invalidate mandatory arbitration clauses in employment and consumer disputes, as well as in disputes arising from civil rights violations. See "Hyperlink: Arbitration Fairness Act Bill". The AFA is a proposed bill to amend the FAA. Under the Commerce Clause, Congress has the power to limit the use of mandatory arbitration, just as it has the power to enforce mandatory arbitration clauses under the Commerce Clause through the existing FAA. By passing a new law that excludes certain types of disputes from being subjected to mandatory arbitration, Congress could set new policy regarding fairness in dispute resolution. Likewise, if it fails to act, Congress is also acceding to the U.S. Supreme Court's broad interpretation of the FAA as a national policy favoring arbitration. Either way, policy regarding mandatory arbitration exists, and Congress has a central role in defining that policy.

Hyperlink: Arbitration Fairness Act Bill

thomas.loc.gov/cgi-bin/query/z?c111:H.R.1020

Review the Arbitration Fairness Act Bill, which would amend the Federal Arbitration Act.

In 1925, when the FAA was originally passed, records indicate that Congress intended that mandatory arbitration clauses be enforced in contracts between merchants, rather than between businesses and consumers or between employers and employees. In the latter relationships, the parties have vastly unequal power. Moreover, despite the existence of mandatory arbitration clauses in contracts, the FAA was not contemplated as a means to preempt state power to provide judicial forums for certain types of disputes. Margaret L. Moses, *Statutory Misconstruction: How the Supreme Court Created a Federal Arbitration Law Never Enacted by Congress*, 34 Fla. St. U.L. Rev. 99 (2006). However, the U.S. Supreme Court has greatly expanded the FAA's applicability since then.

If Congress passed the AFA, this would be an example of one branch of government "checking" another branch's power as contemplated by the U.S. Constitution. Specifically, the legislative branch would be checking the judicial branch's power by passing a law to counteract the U.S. Supreme Court's broad interpretation of the FAA in *Southland Corp. v. Keating*.

This is how our government is supposed to work. One branch checks another branch's power. This "checking" of power maintains relative balance among the branches. Because people have different points of entry into the lawmaking process, this system ultimately balances the many special interests of the American people. For example, some businesses and employers that do not wish the AFA to pass may wonder what recourse they have. After all, the U.S. Supreme Court's interpretation of the FAA currently favors their interests. Since the AFA has not yet passed, they could lobby lawmakers against its passage. Note too that if the AFA becomes law, these interest groups are not simply shut out of the government's lawmaking process. They continue to have access to lawmaking. One point of entry is through the legislative branch. For instance, they could return to Congress and ask it to pass a

new law to counteract the AFA, or to repeal the AFA altogether. They also have a point of entry to the lawmaking process through the judicial branch. Specifically, once a case or controversy arose under the AFA in which they had standing, they could ask the courts to interpret the statute narrowly, or they could ask the courts to strike down the statute altogether.

On the other side of the issue, consumers and employees who do not like the FAA's current broad interpretation can work within our government system to change the law. For instance, they can ask Congress to pass a new law, such as the AFA. They could ask Congress to repeal the FAA. They could also wait for another case to arise under the FAA to try to get the relevant holding in the *Southland Corp.* case overturned. This is perhaps more difficult than the first two options, because any U.S. Supreme Court case produces many progeny at the circuit court level. Each decision at the circuit court level also produces binding precedent within that jurisdiction. It is very difficult to get a case before the U.S. Supreme Court. Even if that happened, there would be no guarantee that the Court would overturn a prior opinion. In fact, the opposite is usually true. Precedent is most often followed rather than overturned.

In the United States, the policy process is open for participation, though changes often take much work and time. People with special interests tend to coalesce and press for changes in the law to reflect those positions. This appears to be what is happening in the world of ADR now. After many years of mandatory arbitration requirements that have yielded perhaps unfair processes or results, groups that believe they should not be forced into ADR by mandatory arbitration clauses are building momentum for their position in Congress. If the AFA passes, that will not be the end of the story, however. New interest groups may form to support the previous law, or a new law altogether.

Key Takeaways

Public policy regarding arbitration has been codified in the FAA and expanded by the U.S. Supreme Court. To change public policy, interest groups can access the government lawmaking power through several points, including through the legislative branch and through the judicial branch. To change public policy regarding mandatory arbitration clauses, for instance, Congress could amend or repeal the FAA. Additionally, given another dispute arising under the FAA concerning its scope, the U.S. Supreme Court could overturn prior decisions that broadly interpret the FAA's reach. Our government's structure allows several points of access for those who would protect the status quo of public policy and for those who seek to change it. The U.S. government is a dynamic system that provides opportunities for special interests to coalesce and change the law and public policy.

? Exercise 6.6.1

1. How many points of entry are there into lawmaking processes? Which point would be the easiest to access if you wanted to change the law? Why?
2. Check out "Hyperlink: Arbitration Fairness Act Bill". Do you think that the AFA will solve the issue of perceived unfairness in dispute resolution? Why or why not? Are there any additions that you can make to this bill to make it more likely to achieve the goal of greater fairness in dispute resolution, if passed?

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6.7: Concluding Thoughts

Alternative dispute resolution (ADR) is a popular and common group of methods to resolve disputes in many different contexts. In business, ADR is commonly used in business to business (B2B), business to consumer (B2C), and business to employee (B2E) disputes. Several methods of ADR exist. The most commonly employed methods include negotiation, mediation, and arbitration. Under federal law, national policy favors arbitration. Sometimes ADR is perceived as unfair, because parties have unequal power relative to each other or because the subject matter of the dispute is not considered suitable for ADR. Like other areas of law and public policy, ADR is dynamic and subject to change, particularly when special interest groups coalesce successfully and create momentum for change within our legal system. Currently, there is a nascent movement to exclude certain types of disputes from ADR by amending the federal law that requires mandatory arbitration when parties have contractually consented to it.

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CHAPTER OVERVIEW

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7.1: Cases

Burger King v. Rudzewicz

Burger King Corp. v. Rudzewicz

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

Summary

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

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

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

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

Justice Brennan delivered the opinion of the court.

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

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

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

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

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

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

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

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

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

It is so ordered.

? Case Questions

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

Ferlito v. Johnson & Johnson

Ferlito v. Johnson & Johnson Products, Inc.

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

Gadola, J.

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

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

MOTION FOR JUDGMENT NOTWITHSTANDING THE VERDICT

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

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

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

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

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

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

…

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

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

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

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

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

ORDER

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

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

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

? Case Questions

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

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

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7.2: Introduction- Courts and the Legal Process

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

Robinson v. Audi

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

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

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

Learning Objectives

After reading this chapter, you should understand the following:

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

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

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

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

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

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

State Court Systems

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

Limited Jurisdiction Courts

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

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

General Jurisdiction Courts

All other civil and criminal cases are heard in the general trial courts, or courts of general jurisdiction. These go by a variety of names: superior, circuit, district, or common pleas court (New York calls its general trial court the supreme court). These are the courts in which people seek redress for incidents such as automobile accidents and injuries, or breaches of contract. These state courts also prosecute those accused of murder, rape, robbery, and other serious crimes. The fact finder in these general jurisdiction courts is not a judge, as in the lower courts, but a jury of citizens.

Although courts of general jurisdiction can hear all types of cases, in most states more than half involve family matters (divorce, child custody disputes, and the like). A third were commercial cases, and slightly over 10 percent were devoted to car accident cases and other torts (as discussed in Chapter 7).

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

Appellate Courts

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

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

The Federal Court System

District Courts

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

Courts of Appeal

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

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

United States Supreme Court

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



Figure 3.1 The Federal Judicial Circuits

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

Key Takeaway

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

Exercises

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

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7.4: The Problem of Jurisdiction

Learning Objectives

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

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

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

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

The Federal-State Balance: Federalism

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

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

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

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

before our federal courts were created, and you can tell from Article III that the founders did not specify that tort or negligence claims should be handled by the federal courts. Again, federal courts are courts of limited jurisdiction, limited to the kinds of cases specified in Article III. If the case before the federal court does not fall within one of those categories, the federal court cannot constitutionally hear the case because it does not have subject matter jurisdiction.

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

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

Exclusive Jurisdiction in Federal Courts

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

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

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

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

8. *Securities and banking regulation*. The body of law protecting the public by regulating the registration, offering, and trading of securities and the regulation of banking practices.
9. *Other cases specified by federal statute*. Any other cases specified by a federal statute where Congress declares that federal courts will have exclusive jurisdiction.

Concurrent Jurisdiction

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

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

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

Summary of Rules on Subject Matter Jurisdiction

1. A court must always have subject matter jurisdiction, and personal jurisdiction over at least one defendant, to hear and decide a case.
2. A state court will have subject matter jurisdiction over any case that is not required to be brought in a federal court.Some cases can *only* be brought in federal court, such as bankruptcy cases, cases involving federal crimes, patent cases, and Internal Revenue Service tax court claims. The list of cases for exclusive federal jurisdiction is fairly short. That means that almost any state court will have subject matter jurisdiction over almost any kind of case. If it's a case based on state law, a state court will always have subject matter jurisdiction.
3. A federal court will have subject matter jurisdiction over any case that is either based on a federal law (statute, case, or US Constitution)ORA federal court will have subject matter jurisdiction over any case based on state law where the parties are (1) from different states and (2) the amount in controversy is at least $75,000.(1) The different states requirement means that no plaintiff can have permanent residence in a state where any defendant has permanent residence—there must be complete diversity of citizenship as between all plaintiffs and defendants.

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

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

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

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

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

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

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

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

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

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

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

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

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

Robinson v. Audi

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

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

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

Table 7.4.1: Sample Conflict-of-Law Principles

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

Legal Procedure, Including Due Process and Personal Jurisdiction

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

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

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

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

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

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

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

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

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

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

How a Case Proceeds

Complaint and Summons

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

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

Jurisdiction and Venue

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

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

Service of Process and Personal Jurisdiction

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

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

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

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

Summary of Rules on Personal Jurisdiction

1. Once a court determines that it has subject matter jurisdiction, it must find at least one defendant over which it is "fair" (i.e., in accord with due process) to exercise personal jurisdiction.
2. If a plaintiff sues five defendants and the court has personal jurisdiction over just one, the case can be heard, but the court cannot make a judgment against the other four.
    1. But if the plaintiff loses against defendant 1, he can go elsewhere (to another state or states) and sue defendants 2, 3, 4, or 5.
    2. The court's decision in the first lawsuit (against defendant 1) does not determine the liability of the nonparticipating defendants.

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

Again, let's consider Mrs. Robinson and her children in the Audi accident. She could file a lawsuit anywhere in the country. She could file a lawsuit in Arizona after she establishes residency there. But while the Arizona court would have subject matter jurisdiction over any products-liability claim (or any claim that was not required to be heard in a federal court), the Arizona court

would face an issue of "*in personam* jurisdiction," or personal jurisdiction: under the due process clause of the Fourteenth Amendment, each state must extend due process to citizens of all of the other states. Because fairness is essential to due process, the court must consider whether it is fair to require an out-of-state defendant to appear and defend against a lawsuit that could result in a judgment against that defendant.

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

Choice of Law and Choice of Forum Clauses

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

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

Key Takeaway

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

Exercises

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

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

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

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7.5: Motions and Discovery

Learning Objectives

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

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

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

Initial Pleadings, and Motions to Dismiss

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

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

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

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

Discovery

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

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

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

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

Key Takeaway

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

Exercises

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

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7.6: The Pretrial and Trial Phase

Learning Objectives

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

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

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

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

Pretrial Conference

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

Trial

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Posttrial Motions

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

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

Rule 50(b) says,

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

Key Takeaway

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

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

Exercises

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

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7.7: Judgment, Appeal, and Execution

Learning Objectives

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

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

Judgment or Order

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

Appeal

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

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

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

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

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

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

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

Judgment and Order

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

Key Takeaway

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

Exercises

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

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7.8: When Can Someone Bring a Lawsuit?

Learning Objectives

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

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

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

Case or Controversy: Standing to Sue

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

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

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

Class Actions

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

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

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

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

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

Key Takeaway

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

Exercises

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

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7.9: Relations with Lawyers

Learning Objectives

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

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

Legal Fees

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

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

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

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

Costs

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

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

Key Takeaway

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

Exercises

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

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

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7.10: Alternative Means of Resolving Disputes

Learning Objectives

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

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

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

Arbitration

Beginning around 1980, a movement toward alternative dispute resolution began to gain force throughout the United States. Bar associations, other private groups, and the courts themselves wanted to find quicker and cheaper ways for litigants and potential litigants to settle certain types of quarrels than through the courts. As a result, neighborhood justice centers or dispute resolution centers have sprung up in communities. These are where people can come for help in settling disputes, of both civil and criminal nature, that should not consume the time and money of the parties or courts in lengthy proceedings.

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

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

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

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

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

Mediation

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

Key Takeaway

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

Exercises

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

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CHAPTER OVERVIEW

8: Torts

8.1: Introduction
8.2: Intentional Torts
8.3: Negligence
8.4: Strict Liability
8.5: Concluding Thoughts

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8.1: Introduction

Learning Objectives

Whenever a company or individual acts unreasonably and causes injury, that person or company may be liable for a tort. In some cases it doesn't matter how careful or reasonable the company or individual is—they may be liable for any injury resulting from their actions. Torts are an integral part of our civil law, and in this chapter, you'll learn about what kinds of torts exist and how to defend yourself or your company from potential tort liability. Specifically, you should be able to answer the following questions:

- What are torts?
- What are intentional torts, and how does one defend against an accusation of one?
- What is negligence and how does it affect virtually all human activity?
- What is strict liability and how does it affect businesses engaged in making and selling products?
- What are the arguments for and against tort reform?

Look at the picture in Figure 8.1.1. You've probably seen a similar picture of a construction site near where you live, with multiple orange traffic cones (with reflective stripes so they can be seen at night) and a large sign warning vehicles not to attempt to drive on the road. Now imagine the picture without the traffic cones, warning signs, or caution tape. If you were driving, would you still attempt to drive on this road?

Most of us would probably answer no, since the road is obviously under construction and attempting to drive on it may result in severe damage to property (our vehicles) and personal injury. Similarly, pedestrians, skateboarders, and bicyclists will likely steer clear of this road even if it wasn't clearly marked or roped off. So if the dangers associated with this construction are obvious, why would the construction workers go through the time and expense of setting up the traffic cones, sign, and tape?



Figure 8.1.1: A Typical Construction Site

The answer has to do with tort law. A tort can be broadly defined as a civil wrong, other than breach of contract. In other words, a tort is any legally recognizable injury arising from the conduct (or nonconduct, because in some cases failing to act may be a tort) of persons or corporations. The other area of civil law that corporations have to be concerned about is contract law. There are several key differences between torts and contracts.

First is the realm of possible plaintiffs. In contract law, only persons that you have a contract with, or you are a third-party-beneficiary to (such as when you are named the beneficiary to a life insurance policy and the company refuses to pay the claim), can possibly sue you for breach of contract. In tort law, just about anyone can sue you, as long as they can establish that you owe them some sort of legally recognized duty. The second key difference is damages, or remedies. In contract law, damages are usually not difficult to calculate, as contract law seeks to place the parties in the same position as if the bargain had been performed (known

as compensatory damages). Compensatory damages also apply in tort law, but they are much more difficult to calculate. Since money cannot bring the dead back to life or regrow a limb, tort law seeks to find a suitable monetary equivalent to those losses, which as you can imagine is a very difficult thing to do. Additionally, tort law generally allows for the award of punitive damages, something never permitted in contract law.

There is also some intersection between tort law and criminal law. Often, the same conduct can be both a crime and a tort. If Claire punches Charlie in the gut, for example, without provocation and for no reason, then Claire has committed the tort of battery and the crime of battery. In the tort case, Charlie could sue Claire in civil court for money damages (typically for his pain, suffering, and medical bills). That case would be tried based on the civil burden of proof—preponderance of the evidence. That same action, however, could also lead Charlie to file a criminal complaint with the prosecutor's office. Society is harmed when citizens punch each other in the gut without provocation or justification, so the prosecutor may file a criminal case against Claire, where the people of the state would sue her for the crime of battery. If convicted beyond a reasonable doubt, Claire may have to pay a fine to the people (the government) and may lose her liberty. Charlie gets nothing specifically from Claire in the criminal case other than the general satisfaction of knowing that his attacker has been convicted of a crime.

You might recall from Chapter 3 "Litigation" that the standard of proving a criminal case (beyond a reasonable doubt) is far higher than the standard for proving a civil case (a preponderance of evidence). Therefore, if someone is convicted of a crime, he or she is also automatically liable in civil tort law under the negligence per se doctrine. For that reason, criminal defendants who wish to avoid a criminal trial are permitted to plead "no contest" to the criminal charges, which permits the judge to sentence them as if they were guilty but preserves the right of the defendant to defend a civil tort suit.

Perhaps more than any other area of law, tort law is a reflection of American societal values. Contracts are enforced because they protect our expectation that our promises are enforced. Criminal law is the result of elected legislatures prohibiting behavior that the community finds offensive or immoral. Tort law, on the other hand, is generally not the result of legislative debate or committee reports. Each tort case arises out of different factual situations, and a jury of peers is asked to decide whether or not the tortfeasor (the person committing the tort) has violated a certain societal norm. Additionally, we expect that when an employee is working for the employer's benefit and commits a tort, the employer should be liable. Under the respondeat superior doctrine, employers are indeed liable, unless they can demonstrate the employee was on a frolic and detour at the time he or she committed the tort.

The norms that society protects make up the basis for tort law. For example, we have an expectation that we have the right to move freely without interference unless detained pursuant to law. If someone interferes with that right, he or she commits the tort of false imprisonment. We have an expectation that if someone spills a jug of milk in a grocery store, the store owners will promptly warn other customers of a slippery floor and clean up the spill. Failure to do so might constitute the tort of negligence. Likewise, we expect that the products we purchase for everyday use won't suddenly and without explanation injure us, and if that happens then a tort has taken place.

It has been said many times that tort law is a unique feature of American law. In Asian countries that follow a Buddhist tradition, for example, many people have a belief that change is a constant part of life and to resist that change is to cause human suffering. Rather than seeking to blame someone else for change (such as an injury, death, or damage to personal property), a Buddhist may see it as part of that person's or thing's "nature" to change. In countries with an Islamic tradition, virtually all events are seen as the will of God, so an accident or tragedy that leads to injury or death is accepted as part of one's submission to God. In the United States, however, the tradition is one of questioning and inquiry when accidents happen. Indeed, it can be said with some truth that many Americans believe there is no such thing as an accident—if someone is injured or killed unexpectedly, we almost immediately seek to explain what happened (and then often place blame).

Torts can be broadly categorized into three categories, depending on the level of intent demonstrated by the tortfeasor. If the tortfeasor acted with intent to cause the damage or harm that results from his or her action, then an intentional tort has occurred. If the tortfeasor didn't act intentionally but nonetheless failed to act in a way a reasonable person would have acted, then negligence has taken place. Finally, if the tortfeasor is engaged in certain activities and someone is injured or killed, then under strict liability the tortfeasor is held liable no matter how careful or careless he or she may have been. In this chapter, we'll explore these three areas of torts carefully so that by the end of the chapter, you'll understand the responsibilities tort law imposes on both persons and corporations. The chapter concludes with a brief discussion of other issues that affect torts, including tort reform.

Key Takeaways

A tort is a civil wrong (other than breach of contract) arising out of conduct or nonconduct that violates societal norms as determined by the judicial system. Unlike contracts and crimes, torts do not require legislative action. Torts protect certain expectations we cherish in a free society, such as the right to travel freely and to enjoy our property. There are three primary areas of tort law, classified depending on the level of intent demonstrated by the tortfeasor.

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8.2: Intentional Torts

Learning Objectives

- Explore what constitutes an intentional tort.
- Study various intentional torts in detail.
- Examine the defenses to intentional torts.

In an intentional tort, the tortfeasor intends the consequences of his or her act, or knew with substantial certainty that certain consequences would result from the act. This intent can be transferred. For example, if someone swings a baseball bat at you, you see it coming and duck, and the baseball bat continues to travel and hits the person standing next to you, then the person hit is the victim of a tort even if the person swinging the bat had no intention of hitting the victim.

In addition to the physical pain that accompanies being strangled by a coworker, the victim may also feel a great deal of fear. That fear is something we expect to never have to feel, and that fear creates the basis for the tort of assault. An assault is an intentional, unexcused act that creates in another person a reasonable apprehension or fear of immediate harmful or offensive contact. Note that actual fear is not required for assault—mere apprehension is enough. For example, have you ever gone to sit down on a chair only to find out that one of your friends has pulled the chair away, and therefore you are about to fall down when you sit? That sense of apprehension is enough for assault. Similarly, a diminutive ninety-pound woman who attempts to hit a burly three-hundred-pound police officer with her bare fists is liable for assault if the police officer feels apprehension, even if fear is unlikely or not present. Physical injuries aren't required for assault. It's also not necessary for the tortfeasor to intend to cause apprehension or fear. For example, if someone pointed a very realistic-looking toy pistol at a stranger and said "give me all your money" as a joke, it would still constitute assault if a reasonable person would have perceived fear or apprehension in that situation. The intentional element of assault exists here, because the tortfeasor intended to point the realistic-looking toy pistol at the stranger.

A battery is a completed assault. It is any unconsented touching, even if physical injuries aren't present. In battery, the contact or touching doesn't have to be in person. Grabbing someone's clothing or cane, swinging a baseball bat at someone sitting in a car, or shooting a gun (or Nerf ball, for that matter, if it's unconsented) at someone is considered battery. Notice that assault and battery aren't always present together. Shooting someone in the back usually results in battery but not assault since the victim didn't see the bullet coming and therefore did not feel fear or apprehension. Similarly, a surgeon who performs unwanted surgery or a dentist who molests a patient while the patient is sedated has committed battery but not assault. Sending someone poisoned brownies in the mail would be battery but not assault. On the other hand, spitting in someone's face, or leaning in for an unwanted kiss, would be assault and possibly battery if the spit hit the victim's face, or the kiss connected with any part of the victim's body.

When someone is sued for assault or battery, several defenses are available. The first is consent. For example, players on a sports team or boxers in a ring are presumed to have consented to being battered. Self-defense and defense of others are also available defenses, bearing in mind that any self-defense must be proportionate to the initial force.

A battery must result in some form of physical touching of the plaintiff. When that physical touching is absent, courts sometimes permit another tort to be claimed instead, the tort of intentional infliction of emotional distress (IIED). In a sense, IIED can be thought of as battery to emotions, but a great deal of caution is warranted here. Many people are battered emotionally every day to varying degrees. Someone may cut you off in traffic, leading you to curse at him or her in anger. A stranger may cut in line in front of you, leading you to exclaim in indignation. A boyfriend or girlfriend may decide to break off a relationship with you, leading to hurt feelings and genuine grief or pain. None of these situations, nor any of the normal everyday stresses of day-to-day living, are meant to be actionable in tort law. The insults, indignities, annoyances, or even threats that we experience as part of living in modern society are to be expected. Instead, IIED is meant to protect only against the most extreme of behaviors. In fact, for a plaintiff to win an IIED case, the plaintiff has to demonstrate that the defendant acted in such a manner that if the facts of the case were told to a reasonable member of the community, that community member would exclaim that the behavior is "outrageous." Notice that the standard here is objective; it's not enough for the plaintiff to feel that the defendant has acted outrageously. In some states, the concern that this tort could be abused and result in frivolous litigation has led to the additional burden that the plaintiff must demonstrate some physical manifestation of the psychological harm (such as sleeplessness or depression) to win any recovery.

Hyperlink: Does Picketing a Fallen Soldier's Funeral Constitute IIED or Constitutionally Protected Speech?

http://www.npr.org/templates/story/story.php?storyId=5192571

The Westboro Baptist Church is a small (approximately seventy-member) fundamentalist church based in Topeka, Kansas. Members of the church, led by their pastor, Fred Phelps, believe that American soldier deaths in Iraq and Afghanistan are punishment from God for the country's tolerance of homosexuality. Church members travel around the country to picket at the funerals of fallen soldiers with large bold signs. Some of the signs proclaim "Thank God for Dead Soldiers." In 2006 members of the church picketed the funeral of Marine Lance Corporal Matthew Snyder, and Snyder's father sued Phelps and the church for IIED and other tort claims. The jury awarded Snyder's family over $5 million in damages, but on appeal, the U.S. Court of Appeals for the Fourth Circuit overturned the verdict. The court found the speech "distasteful and repugnant" but pointed out that "judges defending the Constitution must sometimes share their foxhole with scoundrels of every sort, but to abandon the post because of the poor company is to sell freedom cheaply. It is a fair summary of history to say that the safeguards of liberty have often been forged in controversies involving not very nice people."*Snyder v. Phelps*, 580 F.3d 206 (4th Cir. 2009), pacer.ca4.uscourts.gov/opinion.pdf/081026.P.pdf (accessed September 27, 2010). Adding insult to injury, the Court of Appeals ordered Snyder's family to pay over $16,000 in legal fees to the church, which led to an outpouring of support for Snyder on Facebook."I Support Al Snyder in His Fight against Westboro Baptist Church," Facebook. www.facebook.com/group.php?v=wall&ref=ts&gid=355406162379 (accessed September 27, 2010). The U.S. Supreme Court has accepted the case.

Although the standard for outrageous conduct is objective, the measurement is made against the particular sensitivities of the plaintiff. Exploiting a known sensitivity in a child, the elderly, or pregnant women can constitute IIED. A prank telephone call made by someone pretending to be from the army to a mother whose son was at war, telling the mother her son has been killed, would most certainly be IIED.

Companies must be careful when handling sensitive employment situations to avoid potential IIED liability. This is especially true when terminating or laying off employees. Such actions must be taken with care and civility. Similarly, companies involved in a lot of public interactions should be careful of this tort as well. Bill collectors and foreclosure agencies must be careful not to harass, intimidate, or threaten the people they deal with daily. In one foreclosure case, for example, Bank of America was sued by a mortgage borrower when the bank's local contractor entered the home of the borrower, cut off utilities, padlocked the door, and confiscated her pet parrot for more than a week, causing severe emotional distress. James Hagerty, "Bank Sorry for Taking Parrot," *Wall Street Journal*, March 11, 2010, A1. In 2006, Walgreens was sued for IIED when pharmacists accidentally stapled a form to patient drugs that was not meant to be seen by patients. The form was supposed to annotate notes about patients, but some pharmacists filled in the form with comments such as "Crazy! She's really a psycho! Do not say her name too loud; never mention her meds by name.""Walgreens Pharmacists Mock You behind Your Back," *The Consumerist*, March 8, 2006, consumerist.com/2006/03/walgreens-pharmacists-mock-you-behind-your-back.html (accessed September 27, 2010).



Figure 8.2.1: Russell Christoff. Source: www.sfgate.com/c/pictures/2005/02/02/mn_nestle_model2.jpg.

Another intentional tort is the invasion of privacy. There are several forms of this tort, with the most common being misappropriation. Misappropriation takes place when a person or company uses someone else's name, likeness, or other identifying characteristic without permission. For example, in 1986 model Russell Christoff posed for a photo shoot for Nestlé Canada for Taster's Choice coffee. He was paid $250 and promised $2,000 if Nestlé used his photo on its product. In 2002 he discovered Nestlé had indeed used his photo on Taster's Choice coffee without his permission (Figure 7.2.1 "Russell Christoff"), and he sued Nestlé for misappropriation. A California jury awarded him over $15 million in damages. Jaime Holguin, "$15.6M Award for Coffee 'Mug,'" *CBSnews.com*, February 2, 2005, www.cbsnews.com/stories/2005/02/01/national/main670754.shtml (accessed September 27, 2010). Misappropriation can be a very broad tort because it covers more than just a photograph or drawing being used without permission—it covers any likeness or identifying characteristic. For example, in 1988 Ford Motor Company approached Bette Midler to sing a song for a commercial, which she declined to do. The company then hired someone who sounded just like Midler to sing one of Midler's songs, and asked her to sound as much like Midler as possible. The company had legally obtained the copyright permission to use the song, but Midler sued anyway, claiming that the company had committed misappropriation by using someone who sounded like her to perform the commercial. An appellate court held that while Ford did not commit copyright infringement, it had misappropriated Midler's right to publicity by hiring the sound-alike, *Midler v. Ford Motor Company*, 849 F.3d 460 (9th Cir. 1988). and a jury awarded her over $400,000 in damages.

In addition to someone's voice, an identifying characteristic can be the basis for misappropriation. For example, Samsung Electronics ran a series of print advertisements to demonstrate how long-lasting their products can be. The ads featured a common item from popular culture along with a humorous tagline. One of the ads featured a female robot dressed in a wig, gown, and jewelry posed next to a game show board that looked exactly like the game show board from Wheel of Fortune (Figure 7.2.2 "Samsung Advertisement"). The tagline said, "Longest-running game show. 2012 A.D." An appellate court held that Vanna White's claim for misappropriation was valid, writing "the law protects the celebrity's sole right to exploit [their identity] value whether the celebrity has achieved her fame out of rare ability, dumb luck, or a combination thereof."*White v. Samsung Electronics America*, 971 F.2d 1395 (9th Cir. 1992). The lesson for companies is that in product marketing, permission must be carefully obtained from all persons appearing in their marketing materials, as well as any persons who might have a claim to their likeness or identifying characteristic in the materials.



Figure 8.2.2: Samsung Advertisement. Source: Photo courtesy of the U.S. federal government, commons.wikimedia.org/wiki/File:White-v-samsung-dissent-appendix-2.png.

Video Clip: Is a Single Name a Likeness or Identifying Characteristic?

(click to see video)

Invasion of privacy can also take the form of an invasion of physical solitude. Actions such as window peeping, eavesdropping, and going through someone's garbage to find confidential information such as bank or brokerage statements are all examples of this form of tort. Media that are overly aggressive in pursuing photos of private citizens may sometimes run afoul of this tort.

Another important intentional tort for businesses is false imprisonment. This tort takes place when someone intentionally confines or restrains another person's movement or activities without justification. The interest being protected here is your right to travel and move about freely without impediment. This tort requires an actual and present confinement. If your professor locks the doors to the classroom and declares no one may leave, that is false imprisonment. If the professor leaves the doors unlocked but declares that anyone who leaves will get an F in the course, that is not false imprisonment. On the other hand, a threat to detain personal property can be false imprisonment, such as if your professor grabs your laptop and says, "If you leave, I'll keep your laptop." Companies that engage in employee morale-building activities should bear in mind that forcing employees to do something they don't want to do raises issues of false imprisonment. False imprisonment is especially troublesome for retailers and other businesses that interact regularly with the public, such as hotels and restaurants. If such a business causes a customer to become arrested by the police, for example, it may lead to the tort of false imprisonment. In one case, a pharmacist who suspected a customer of forging a prescription deliberately caused the customer to be detained by the police. When the prescription was later validated, the pharmacist was sued for false imprisonment. Businesses confronted with potential thieves are permitted to detain suspects until police arrive at the establishment; this is known as the shopkeeper's privilege. The detention must be reasonable, however. Store employees must not use excessive force in detaining the suspect, and the grounds, manner, and time of the detention must be reasonable or the store may be liable for false imprisonment.

Intentional torts can also be committed against property. Trespass to land occurs whenever someone enters onto, above, or below the surface of land owned by someone else without the owner's permission. The trespass can be momentary or fleeting. Soot, smoke, noise, odor, or even a flying arrow or bullet can all become the basis for trespass. A particular trespass problem takes place in suburban neighborhoods without clearly marked property lines between homes. Children are often regular trespassers in this area, and even if they are trespassing, homeowners are under a reasonable duty of care to ensure they are not harmed. When there is an attractive nuisance on the property, homeowners must take care to both warn children about the attractive nuisance and protect them from harm posed by the attractive nuisance. This doctrine can apply to pools, abandoned cars, refrigerators left out for collection, trampolines, piles of sand or lumber, or anything that might pose a danger to children and that they cannot understand or appreciate. There may be times, however, when trespass is justified. Obviously, someone invited by the owner is not a trespasser; such a person is considered an invitee until the owner asks him or her to leave. Someone may have a license to trespass, such as a meter reader or utility repair technician. There may also be times when it may be necessary to trespass—for example, to rescue someone in distress.

Trespass to personal property is the unlawful taking or harming of another's personal property without the owner's permission. If your roommate borrowed your vehicle without your permission, for example, it would be trespass to personal property. The tort of conversion takes place when someone takes your property permanently; it is the civil equivalent to the crime of theft. If you gave your roommate permission to borrow your car for a day and he or she stole your car instead, it would be conversion rather than trespass. An employer who refuses to pay you for your work has committed conversion.

Another intentional tort is defamation, which is the act of wrongfully hurting a living person's good reputation. Oral defamation is considered slander, while written defamation is libel. To be liable for defamation, the words must be published to a third party. There is no liability for defamatory words written in a secret diary, for example, but there is liability for defamatory remarks left on a Facebook wall. Issues sometimes arise with regard to celebrities and public figures, who often believe they are defamed by sensationalist "news" organizations that cover celebrity gossip. The First Amendment provides strong protection for these news organizations, and courts have held that public figures must show actual malice before they can win a defamation lawsuit, which means they have to demonstrate the media outlet knew what it was publishing was false or published the information with reckless disregard for the truth. This is a much higher standard than that which applies to ordinary citizens, so public figures typically have a difficult time winning defamation lawsuits. Of course, truth is a complete defense to defamation.

Defamation can also take place against goods or products instead of people. In most states, injurious falsehood (or trade disparagement) takes place when someone publishes false information about another person's product. For example, in 1988 the influential product testing magazine *Consumer Reports* published a test of the Suzuki Samurai small SUV, claiming that it "easily rolls over in turns." Product sales dropped sharply, and Suzuki sued Consumers Union, the publisher, for trade disparagement. The case was settled nearly a decade later after a long and expensive legal battle.

Businesses often make claims about their products in marketing their products to the public. If these claims are false, then the business may be liable for the tort of misrepresentation, known in some states as fraud. Fraud requires the tortfeasor to misrepresent facts (not opinions) with knowledge that they are false or with reckless disregard for the truth. An "innocent" misrepresentation, such as someone who lies without knowing he or she is lying, is not enough—the defendant must know he or she is lying. Fraud can arise in any number of business situations, such as lying on your résumé to gain employment, lying on a credit application to obtain credit or to rent an apartment, or in product marketing. Here, there is a fine line between puffery, or seller's talk, and an actual lie. If an advertisement claims that a particular car is the "fastest new car you can buy," then fraud liability arises if there is in fact a car that travels faster. On the other hand, an advertisement that promises "unparalleled luxury" is only puffery since it is opinion. Makers of various medicinal supplements and vitamins are often the target of fraud lawsuits for making false claims about their products.

Finally, an important intentional tort to keep in mind is tortious interference. This tort, which varies widely by state, prohibits the intentional interference with a valid and enforceable contract. If the defendant knew of the contract and then intentionally caused a party to break the contract, then the defendant may be liable. In 1983 oil giant Pennzoil made a bid for a smaller oil rival, Getty Oil. A competitor to Pennzoil, Texaco, found out about the deal and approached Getty with another bid for a higher amount, which Getty then accepted. Pennzoil sued Texaco, and a jury awarded over $10 billion in damages.

Key Takeaways

Assault is any intentional act that creates in another person a reasonable fear or apprehension of harmful or offensive contact. A battery is a completed assault, when the harmful or offensive contact occurs. The intentional infliction of emotional distress (IIED) is extreme and outrageous conduct that intentionally causes severe emotional distress to another person. In some states, IIED requires a demonstration of physical harm such as sleeplessness or depression. This is a difficult tort to win because of its inherent clash with values embodied by the First Amendment. Misappropriation is the use of another person's name, likeness, or other identifying characteristic without permission. False imprisonment occurs when someone intentionally confines or restrains another person's movement without justification. Trespass is the entry onto land without the owner's permission, while conversion is the civil equivalent of the theft crime. Defamation is the intentional harm to a living person's reputation, while trade disparagement takes place when someone publishes false information about someone else's product. Fraudulent misrepresentation is any intentional lie involving facts. Tortious interference is the intentional act of causing someone to break a valid and enforceable contract.

? Exercise 8.2.1

1. Members of the Westboro Baptist Church claim that the First Amendment protects them from IIED lawsuits since they are expressing a political opinion by picketing at soldier funerals. The pickets take place on public property and in compliance with local picketing laws. If the plaintiffs win the case, the church is unlikely to have the money to satisfy the judgment and may seek bankruptcy. Do you believe that this conduct is extreme and outrageous enough to constitute a tort? Why or why not?
2. In 1983 *Hustler* magazine (owned by publisher Larry Flynt) ran a print advertisement patterned after a Campari liquor ad campaign. The real ad campaign featured celebrities "talking about their first time" in a question-and-answer interview format, slowly revealing that the celebrities were speaking about their first time drinking Campari. The *Hustler* advertisement featured fundamentalist preacher Jerry Falwell, who was running a campaign against pornography at the time, and insinuated that Falwell had lost his virginity to his mother. Falwell sued Flynt and the magazine, and a jury awarded Falwell $150,000 in damages. The Supreme Court overturned the verdict on appeal on grounds of the First Amendment, holding that as a public figure, Falwell had to endure the advertisement. *Hustler Magazine v. Falwell*, 485 U.S. 46 (1988). Do you believe that celebrities and public figures should have a harder time winning IIED lawsuits? Why or why not?

3. Do you believe that an “identifying characteristic” should be protected by the tort of misappropriation, or do you believe that society has gone too far in recognizing property rights? A First Amendment exception exists for comedians who engage in satire and comedy (think of Tina Fey’s impersonation of Sarah Palin during the 2008 presidential campaign, for example). Does it make sense to you that comedians like Fey and John Stewart can make money through misappropriation, but other businesses cannot?
4. Look at the advertisement featured in "Video Clip: Is a Single Name a Likeness or Identifying Characteristic?". Do you think that the ad is referring to Lindsay Lohan? Has the name “Lindsay” become so linked to Lohan that companies run the risk of being sued if they use the name Lindsay in advertisements? What if the advertisement had used a name like “Oprah” or “Cher”?
5. Defamation law only protects the living. Some legal commentators believe that defamation should also protect the dead. See, for example, law professor Jonathan Turley’s opinion in the *Washington Post* here: www.washingtonpost.com/wp-dyn/content/article/2006/09/15/AR2006091500999_pf.html. Turley points out examples of how the dead have been defamed, such as the character of William Murdoch in the 1997 movie *Titanic*, where he was portrayed as a murderous nut. In reality, survivors reported he took heroic actions to save passengers. Do you believe defamation should be extended to protect the dead as well as the living?

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8.3: Negligence

Learning Objectives

- Learn about whom we owe duties to under the tort of negligence.
- Explore how those duties can be legally breached.
- Discuss how causation, both actual and proximate, can affect liability.
- Examine the requirement to demonstrate damages to win a negligence suit.
- Understand various defenses to negligence.

Video Clip: The Crash of Continental Flight 3407

(click to see video)

Ordinarily, we don't expect perfectly good airplanes to fall out of the sky for no reason. When it happens, and it turns out that the reason was carelessness or a failure to act reasonably, then the tort of negligence may apply. All persons, as established by state tort law, have the duty to act reasonably and to exercise a reasonable amount of care in their dealings and interactions with others. Breach of that duty, which causes injury, is negligence. Negligence is distinguished from intentional torts because there is a lack of intent to cause harm. If a pilot intentionally crashed an airplane and harmed others, for example, the tort committed may be assault or battery. When there is no intent to harm, then negligence may nonetheless apply and hold the pilot or the airline liable, for being careless or failure to exercise due care.

Note that the definition of negligence is purposefully broad. Negligence is about breaching the duty we owe others, as determined by state tort law. This duty is often broader than the duties imposed by law. Colgan Air, for example, may have been fully compliant with applicable laws passed by Congress while still being negligent. In a way, the law of negligence is an expression of democracy at the community and local level, because ultimately, citizen juries (as opposed to legislatures) decide what conduct leads to liability.

To prove negligence, plaintiffs have to demonstrate four elements are present. First, they have to establish that the defendant owed a duty to the plaintiff. Second, the plaintiff has to demonstrate that the defendant breached that duty. Third, the plaintiff has to prove that the defendant's conduct caused the injury. Finally, the plaintiff has to demonstrate legally recognizable injuries. We'll address each of these elements in turn.

First, the plaintiff has to demonstrate that the defendant owed it a duty of care. The general rule in our society is that people are free to act any way they want to, as long as they don't infringe on the freedoms or interests of others. That means that you don't owe anyone a special duty to help them in any way. For example, if you're driving along a deserted rural highway at night in a snowstorm, and you see a car ahead of you fishtail and drive into a ditch, you are entitled to keep driving and do nothing, not even report the accident, because you don't owe that driver any special duty. On the other hand, if you ran a stop sign, which then caused the other driver to drive into a ditch, you would owe that driver a duty of care.

Another way to look at duty is to consider whether or not the plaintiff is a foreseeable plaintiff. In other words, if the risk of harm is foreseeable, then the duty exists. Take, for instance, the act of littering with a banana peel. If you carelessly throw away a banana peel, then it is foreseeable that someone walking along may slip on it and fall, causing injuries. Under tort law, by throwing away the banana peel you now owe a duty to anyone who may be walking nearby who might walk on that banana peel, because any of those persons might foreseeably step on the peel and slip.

An emerging area in tort law is whether or not businesses have a duty to warn or protect customers for random crimes committed by other customers. By definition, crimes are random and therefore not foreseeable. However, some cases have determined that if a business knows about, or should know about, a high likelihood of crime occurring, then that business must warn or take steps to protect its customers. For example, in one case a state supreme court held that when a worker at Burger King ignored a group of boisterous and loud teenagers, Burger King was liable when those teenagers then assaulted other customers. *Iannelli v. Burger King Corp.*, 145 N.H. 190 (2000). In another case, the Las Vegas Hilton was held liable for sexual assault committed by a group of naval aviators because evidence at trial revealed that the hotel was aware of a history of sexual misconduct by the group involved.

The concept of duty is broad and extends beyond those in immediate physical proximity. In a famous case from California, for example, a radio station with a large teenage audience held a contest with a mobile DJ announcing clues to his locations as he moved around the city. The first listener to figure out his location and reach him earned a cash prize. One particular listener, a minor, was rushing toward the DJ when the listener negligently caused a car accident, killing the other driver. During a negligence trial, the radio station argued that hindsight is not foreseeability and that the station, therefore, did not owe the dead driver a duty of care. The California Supreme Court held that when the radio station started the contest, it was foreseeable that a young and inexperienced driver may drive negligently to claim the prize and that therefore a duty of care existed. *Weirum v. RKO General*, 15 Cal.3d 40 (1975). Radio stations should, therefore, be very careful when running promotional contests to ensure that foreseeable deaths or injuries are prevented. This lesson apparently eluded Sacramento station KDND, which in 2007 held a contest titled "Hold Your Wee for a Wii" where contestants were asked to drink a large amount of water without going to the bathroom for the chance of winning a game console. An otherwise healthy twenty-eight-year-old mother died of water intoxication hours after the contest, which led to a lawsuit and a $16 million jury verdict.

The general rules surrounding when a duty exists can be modified in special situations. For example, landowners owe a duty to exercise reasonable care to protect persons on their property from foreseeable harm, even if those persons are trespassers. If you are aware of a weak step or a faucet that dispenses only scalding hot water, for example, you must take steps to warn guests about those known dangers.

Businesses owe a duty to exercise a reasonable degree of care to protect the public from foreseeable risks that the owner knew or should have known about. There are many foreseeable ways for customers to be injured in retail stores, from falling objects improperly placed on high shelves, to light fixtures exploding or falling due to improper installation, to customers being injured by forklifts in so-called warehouse stores. One particular area of concern for businesses is liquid on walking surfaces, which can be very dangerous. Spilled product (milk, orange juice, wine, etc.), melted ice or snow, or rain can cause slick situations, and if a store knows about such a condition, or should have known about it, then the store must quickly warn customers and remedy the situation.

Business professionals such as doctors, accountants, dentists, architects, and lawyers owe a special duty to act as a reasonable person in their profession. Professional negligence by these professionals is known as malpractice. The government estimates that between forty-four thousand and ninety-eight thousand people die each year in hospitals due to medical mistakes, the vast majority of them preventable.U.S. Department of Health and Human Services, Agency for Healthcare Research and Quality, "Reducing Errors in Health Care: Translating Research Into Practice," April 2000, http://www.ahrq.gov/qual/errors.htm (accessed September 27, 2010).

Once duty has been established, negligence plaintiffs have to demonstrate that the defendant breached that duty. A breach is demonstrated by showing the defendant failed to act reasonably, when compared with a reasonable person. It's important to keep in mind that this reasonable person is hypothetical and does not actually exist. This reasonable person is never tired, sleepy, angry, or intoxicated. He or she is reasonably careful—not taking every single precaution to prevent accidents but considering his or her actions and consequences carefully before proceeding. In reality, once a duty has been established, the presence of injury or harm is usually enough to satisfy the "breach of duty" requirement.

The third element of negligence is causation. In deciding whether there is causation, courts have to consider two questions. First, courts query as to whether there is causation in fact, also known as but-for causation. This form of causation is fairly easy to prove. But for the defendant's actions, would the plaintiff have been injured? If yes, then but-for causation is proven. For example, if you are texting while driving and you hit a pedestrian because your attention was diverted, then but-for causation is easily met, because "but for" your actions of texting while driving, you would not have hit the pedestrian.

The second question is tougher to establish. It asks whether the defendant's actions were the proximate cause of the plaintiff's injury. In asking this question, courts are expressing a concern that causation-in-fact can be taken to a logical but extreme conclusion. For example, if a speeding truck driver crashes his or her rig and causes the interstate highway to be shut down for several hours, causing you to become stuck in traffic and miss an important interview, you could argue that but for the truck driver's negligence, you may have landed a new job. It would not be fair, however, to hold the truck driver liable for all the missed appointments and meetings caused by a subsequent traffic jam after the crash. At some point, the law has to break the chain of causation. The truck driver may be liable for injuries caused in the crash, but not beyond the crash. This is proximate causation.

Video Clip: Palsgraf v. Long Island Railroad Company

(click to see video)

In determining whether proximate cause exists, we once again use the foreseeability test, already used for determining whether duty exists. If an injury is foreseeable, then proximate cause exists. If it is unforeseeable, then it does not.

In some cases, it can be difficult to pinpoint a particular source for a product, which then makes proving causation difficult. This is particularly true in mass tort cases where victims may have been exposed to dangerous substances from multiple sources over a number of years. For example, assume that you have been taking a vitamin supplement for a number of years, buying the supplement from different companies that sell it. After a while, the government announces that this supplement can be harmful to health and orders sales to stop. You find out that your health has been affected by this supplement and decide to file a tort lawsuit. The problem is that you don't know which manufacturer's supplement caused you to fall ill, so you cannot prove any specific manufacturer caused your illness. Under the doctrine of joint and several liability, however, you don't have to identify the specific manufacturer that sold you the drug that made you ill. You can simply sue one, two, or all manufacturers of the supplement, and any of the defendants are then liable for the entirety of your damages if they are found liable. This doctrine has been used in cases involving asbestos production and distribution.

The final element in negligence is legally recognizable injuries. If someone walks on a discarded banana peel and doesn't slip or fall, for example, then there is no tort. If someone has been injured, then damages may be awarded to compensate for those injuries. These damages take the form of money, as there is nothing tort law can do to bring back the dead or regrow lost limbs, and tort law does not allow for incarceration. Money is therefore the only appropriate measure of damages, and it is left to the jury to decide how much money a plaintiff should be awarded.

There are two types of award damages in tort law. The first, compensatory damages, seeks to compensate the plaintiff for his or her injuries. Compensatory damages can be awarded for medical injuries, economic injuries (such as loss of a car, property, or income), and pain and suffering. They can also be awarded for past, present, and future losses. While medical and economic damages can be calculated using available standards, pain and suffering is a far more nebulous concept. Juries are often left to their conscience to decide what amount of money can compensate for pain and suffering, based on the severity and duration of the pain as well as its impacts on the plaintiff's life.

The second type of damage award is known as punitive damages. Here, the jury is awarded a sum of money not to compensate the plaintiff but to deter the defendant from ever engaging in similar conduct. The idea behind punitive damages is that compensatory damages may be inadequate to deter future bad conduct, so additional damages are necessary to ensure the defendant corrects its ways to prevent future injuries. Punitive damages are available in cases where the defendant acted with willful and wanton negligence, a higher level of negligence than ordinary negligence. Bear in mind, however, that there are constitutional limits to the award of punitive damages.

A defendant being sued for negligence has three basic affirmative defenses. An affirmative defense is one that is raised by the defendant essentially admitting that the four elements for negligence are present, but that the defendant is nonetheless not liable for the tort. The first defense is assumption of risk. If the plaintiff knowingly and voluntarily assumes the risk of participating in a dangerous activity, then the defendant is not liable for injuries incurred. For example, if you decide to bungee jump, you assume the risk that you might be injured during the jump. It's common for bungee jumpers to experience burst blood vessels in the eye, soreness in the back and neck region, and twisted ankles, so these injuries are not compensable. On the other hand, you can only assume risks that you know about. When a person bungee jumps, one of the first steps is for the jump operator to weigh the jumper, so that the length of the bungee can be adjusted accordingly. If this is not done properly, the jumper may overshoot or undershoot the expected bottom of the jump. While you can assume known risks from bungee jumping, you cannot assume unknown risks, such as the risk that a jump operator may negligently calculate the length of the bungee rope.

A related doctrine, the open and obvious doctrine, is used to defend against suits by persons injured while on someone else's property. For example, if there is a spill on a store's floor and the store owner has put up a sign that says "Caution—Slippery Floor," yet someone decides to run through the spill anyway, then that person would lose a negligence lawsuit if he or she slips and falls because the spill was open and obvious. Use of the open and obvious doctrine varies widely by state, with some states allowing it to be used in a wide variety of premises liability cases and other states circumventing its usefulness.

Both the assumption of risk and open and obvious defenses are not available to the defendant who caused a dangerous situation in the first place. For example, if you negligently start a house fire while playing with matches and evacuate the house with your roommates, if one of your roommates decides to reenter the burning house to rescue someone else, you cannot rely on assumption of risk as a defense since you started the fire.

The second defense to negligence is to allege that the plaintiff's own negligence contributed to his or her injuries. In a state that follows the contributory negligence rule, a plaintiff's own negligence, no matter how minor, bars the plaintiff from any recovery. This is a fairly harsh rule, so most states follow the comparative negligence rule instead. Under this rule, the jury is asked to determine to what extent the plaintiff is at fault, and the plaintiff's total recovery is then reduced by that percentage. For example, if you jaywalk across the street during a torrential thunderstorm and a speeding car strikes you, a jury may determine that you are 20 percent at fault for your injuries. If the jury decides that your total compensatory damage award is $1 million, then the award will be reduced by $200,000 to account for your own negligence.

Finally, in some situations, the Good Samaritan law may be a defense in a negligence suit. Good Samaritan statutes are designed to remove any hesitation a bystander in an accident may have to providing first aid or other assistance. They vary widely by state, but most provide immunity from negligent acts that take place while the defendant is rendering emergency medical assistance. Most states limit Good Samaritan laws to laypersons (i.e., police, emergency medical service providers, and other first responders are still liable if they act negligently) and to medical actions only.

Key Takeaways

Negligence imposes a duty on all persons to act reasonably and to exercise due care in dealing and interacting with others. There are four elements to the tort of negligence. First, the plaintiff must demonstrate the defendant owed the plaintiff a duty. If the risk of injury is foreseeable, then the defendant owes the plaintiff a duty. Second, there must be a breach of that duty. A breach occurs when the defendant fails to act like a reasonable person. Professional negligence is known as malpractice. Third, the plaintiff must demonstrate that the defendant caused the plaintiff's injuries. Both causation-in-fact and proximate causation must be proven. Finally, the plaintiff must demonstrate legally recognizable injuries, which include past, present, and future economic, medical, and pain and suffering damages. Defendants can raise several affirmative defenses to negligence, including assumption of risk, comparative or contributory negligence, and in some cases, Good Samaritan statutes.

? Exercise 8.3.1

1. Does a private investigator owe a duty of care to potential victims of crime if their clients use information obtained by the investigator to commit the crime? In 2003 a court held the answer is yes. In that case, an Internet-based investigative firm charged fees to a client to find out the Social Security number, place of employment, and home and work addresses of a third party. The client then used the information to stalk and kill the third party. The court held that since the risk of harm is foreseeable, the company owed the third party a duty of care. See *Remsburg v. Docusearch, Inc.*, 816 A.2d 1001 (N.H. 2003).
2. In January 2001 a New York man attended a family birthday party at a Benihana restaurant, where chefs, while cooking at the table, routinely throw pieces of food for diners to catch with their mouths. The man wrenched his neck while ducking a piece of flying shrimp, requiring treatment by several doctors. By that summer, doctors determined surgery was necessary to treat numbness in his arm. Five months after surgery, he checked into the hospital with a high fever and died. The family sued Benihana for $10 million in damages, claiming that the fever was the result of surgery, which in turn was the result of the chef's actions in throwing food at diners. Do you believe that Benihana should be liable for the man's death? Why or why not?
3. What kind of duty of care do cities that own and operate public transportation systems owe to the paying and traveling public? On February 4, 2010, Shaun Mills was traveling home on a public bus in Jacksonville Beach, Florida. He missed his regular stop, so he got off at the next stop. The sidewalk at this bus stop was closed, so he crossed the street and was hit by a car. The remarkable accident was captured on video. See http://today.msnbc.msn.com/id/36310494. Mills survived and is suing the bus company. In this case, what defenses are available to the defendant bus company?
4. Medical malpractice claims tens of thousands of lives per year, leaving victims and their families little recourse except through the tort system. Most doctors purchase medical malpractice insurance policies to pay a claim in case they are sued, but in some cases, these premiums can be exorbitantly high. The fear of medical malpractice suits also drives some doctors

> to practice “defensive medicine,” which further increases the price of health care for everyone. How do you think the legal system can best balance these two competing interests?

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8.4: Strict Liability

Learning Objectives

- Explore what strict liability is and when it applies.
- Understand how a product may be unreasonably dangerous, triggering strict liability.
- Learn about how a product's warnings and labels are a part of a product's safe design.
- Examine defenses available to strict product liability.

Intentional torts require some level of intent to be committed, such as the intent to batter someone. Negligence torts don't require intent to harm but require some level of carelessness or neglect. Strict liability torts require neither intent nor carelessness. In fact, if strict liability applies, it is irrelevant how carelessly, or how carefully, the defendant acted. It doesn't matter if the defendant took every precaution to avoid harm—if someone is harmed in a situation where strict liability applies, then the defendant is liable.

Since this rule can have harsh consequences, it applies in a only few limited circumstances. One of those circumstances is when the defendant is engaged in an ultrahazardous activity. An ultrahazardous activity is one that is so inherently dangerous that the risk to human life is great if anything wrong happens, so the person carrying out the ultrahazardous activity is held strictly liable for those activities. Transporting dangerous chemicals or nuclear waste, for example, is inherently dangerous. If the chemicals spill, it is very difficult, if not impossible, to prevent injury to property or persons. Similarly, businesses that use dynamite, such as building demolition crews, run the risk that no matter how careful they are, people or property could be damaged by intentionally igniting dynamite. Therefore, strict liability applies.

Strict liability also applies when restaurants, bars, and taverns serve alcohol to minors or visibly intoxicated persons. This activity is dangerous, and there is a high risk of probability that these patrons, if they drive, will injure others. Many states have dram shop acts that impose strict liability in this circumstance.

You might wonder why defendants are held strictly liable if they are acting reasonably or are even being ultracautious. As with most issues in law, the answer lies in social policy. In essence, strict liability torts exist because businesses that engage in covered activities (such as transporting hazardous chemicals or operating bars) profit from those activities. They are also in the best position to ensure that every precaution can be taken to avoid an unexpected event, which may have catastrophic consequences. Victims of these events are often innocent members of the public who are not in any position to avoid being injured and therefore should not be denied a legal remedy simply because the defendant took prudent precautions. This social policy concern is also expressed in the most important area of strict liability application, strict product liability.

In strict product liability, any retailer, wholesaler, or manufacturer that sells an unreasonably dangerous product is strictly liable. For example, Toyota recently disclosed that it had manufactured and sold several vehicle models with faulty accelerators, leading to several cases of unintended acceleration and subsequent deaths. Vehicles that accelerate unintentionally are clearly unreasonably dangerous. In this case, the manufacturer (Toyota Japan), the wholesaler or importer (Toyota's U.S. sales company), and the retailer (local dealers) are all strictly liable for injuries caused by these faulty accelerators. Note, however, that strict liability applies only to commercial sellers. If a private citizen sold his or her Toyota on Craigslist, for example, he or she would not be strictly liable for selling an unreasonably dangerous product.

To demonstrate that a product is unreasonably dangerous, plaintiffs have two theories available to them. First, they might allege that the product was defective because of a flaw in the manufacturing process. Under this theory, the vast majority of products being produced turn out fine, but due to some sort of production defect, a few samples or a batch turns out defective. If these defective samples are sold to the public, the manufacturer or seller is strictly liable. A light bulb factory that manufactures a million safe light bulbs, for example, and then manufacturers one that explodes when it is turned on due to some production defect, is strictly liable for the injuries caused. Similarly, a frozen pizza factory that produces thousands of pizzas without any trouble would be strictly liable if one frozen pizza is produced that contains foreign contaminants because of a production defect such as an inattentive worker or machine breakdown.

Second, a product may be defective because of a design defect. Here, there is nothing wrong with the manufacturing or production of the product. Rather, the product is defective because it was designed incorrectly or in a manner that causes the product to be unreasonably dangerous. Engineers continually work to design products to be as safe as possible, but in some cases, the product is

nonetheless dangerous, and the manufacturer or seller is strictly liable. For example, starting in 1991 several Boeing 737 jetliners began experiencing unexpected movement in the rudder, leading to several high-profile crashes including a USAir flight in Pittsburgh that killed 132 people."When Jets Crash: How Boeing Fights to Limit Liability," *Seattle Times*, October 30, 1996, seattletimes.nwsource.com/news/local/737/part04 (accessed September 27, 2010). During the course of investigation, the government discovered that the part that controls the rudder gets very cold in flight, and when it is injected with hot hydraulic fluid, the part can jam and move the rudder in the opposite direction of what the pilot is calling for. This design defect was eventually fixed by upgrading the rudder control systems on all existing Boeing 737s worldwide.

Hyperlink: What's Wrong with the Tire?

www.time.com/time/business/article/0,8599,128198,00.html

In 1999 Ford customers in the Middle East began experiencing tread separation problems on Ford Explorer SUVs. The tires would disintegrate, leading to a loss of control and often a rollover crash. The company initially believed that the problem was limited to the Middle East because of unique characteristics there such as extremely hot weather, lowered tire inflation pressures for driving in sand, and harsh operating environments. Soon, however, vehicles in the United States, especially in hotter regions of the country, began experiencing the same problems. The death toll mounted to over 170 deaths and over 700 injuries from these accidents. Ford's investigation led the company to believe that certain fifteen-inch tires manufactured by Firestone were to blame; virtually all the accidents involved Firestone tires manufactured in one plant in Decatur, Illinois (now closed). Similar vehicles equipped with Goodyear tires rarely experienced tread separation problems. Firestone, on the other hand, blamed the Ford Explorer for being defectively designed. Firestone argued that the Explorer lacked critical safety features to lower the center of gravity, reduce the propensity to roll over, and lessen the chance of underinflating the tires. Firestone pointed out that the same tires did not experience any problems when installed on GM vehicles. Whether the fault lay with a production defect in Firestone tires or design defect in Ford Explorers, both companies were strictly liable. Ford spent over $3 billion recalling the tires and ended its one-hundred-year relationship with Firestone. Congress also responded, passing a federal law requiring all vehicles to be equipped with tire pressure monitoring systems.

Many product liability cases arise from the defective design theory because courts have held that the warning labels on products, as well as accompanying literature, are all part of a product's design. A product that might be dangerous if used in a particular way, therefore, must have a warning label or other caution on it, so that consumers are aware of the risk posed by that product. Manufacturers must warn against a wide variety of possible dangers from using their products, as long as the injury is foreseeable. If consumer misuse is foreseeable, manufacturers must warn against that misuse as well. For these reasons, window blinds come with warnings about choking hazards posed by the rope used to raise and lower them, and hair dryers come with warnings about operating them in bathtubs and showers.

While you may think that these warnings are a little silly, keep in mind that products can harm or kill people who don't know how to use them correctly. For example, in one case, a woman traveling in the passenger seat of a GM SUV was killed in a low-speed collision in a parking lot when airbags deployed in a collision. The woman was killed because her seat was reclined and rather than being restrained by the seat and seatbelt, she "submarined" underneath the seat belt and hit the deploying airbag. When her family sued GM, the company argued that seats and seatbelts work only when the seat is in an upright position and that the owner's manual warns not to recline the seat when the vehicle is in motion. The family argued successfully that this warning was not clear and conspicuous enough, and that as a result, many people travel with their seat reclined. Do you believe the lack of a clear and conspicuous warning about the danger of traveling with the seat reclined makes a vehicle's design defective?

Hyperlink: A Near-Fatal Mistake Due to Labeling?

In November 2007 actor Dennis Quaid and his wife Kimberly were celebrating the birth of their newborn twins at Cedars-Sinai Medical Center in Los Angeles. The twins suffered a staph infection, and doctors prescribed a blood thinner to prevent blood clots. The blood thinner, Heparin, comes in two doses, with the heavier dose one thousand times more potent than the lower dose. However, the two doses come in similar packaging with blue labels. Nurses at the hospital inadvertently gave the twins the higher dose, nearly killing the twins. In Indianapolis earlier that year, three premature infants did in fact die from overdosing on Heparin. The Quaids are suing the manufacturer, arguing that the labels on the drug represent a design defect

because it is too easy to confuse the two doses. The manufacturer, Baxter Healthcare, has since changed the design to include a red warning label that must be torn off before the drug can be used.

http://www.usatoday.com/life/people/2007-12-04-quaid-lawsuit_N.htm



Figure 8.4.1: Should these labels be more distinctive to prevent mistakes? Source: http://www.steadyhealth.com/articles/What_do_Anticoagulants_do__a667.html.

There are several defenses to strict product liability. Since product liability is strict liability, the plaintiff's contributory or comparative negligence is not a defense. However, assumption of risk can be a defense. As in negligence, the user must know of the risk of harm and voluntarily assume that risk. For example, someone cutting carrots with a sharp knife voluntarily assumes the risk that the knife may slip and cut him or her, meaning he or she cannot sue the knife manufacturer. However, if the knife blade unexpectedly detaches from the knife handle because of a design or production defect, and injures the user, then there is no assumption of risk since the user would not have known about that particular risk.

Product misuse is another defense to strict product liability. If the consumer misuses the product in a way that is unforeseeable by the manufacturer, then strict liability does not apply. Modifying a lawnmower to operate as a go-kart, for instance, is product misuse. Note that manufacturers are still liable for any misuse that is foreseeable, and they must take steps to warn against that misuse. A related defense is known as the commonly known danger doctrine. If a manufacturer can convince a jury that the plaintiff's injury resulted from a commonly known danger, then the defendant may escape liability.

Key Takeaways

In areas where strict liability applies, the defendant is liable no matter how careful the defendant was in preventing harm. Carrying out ultrahazardous activities results in strict liability for defendants. Another area where strict liability applies is in the serving of alcohol to minors or visibly intoxicated persons. A large area of strict liability applies to the manufacture, distribution, and sale of unreasonably dangerous products. Products can be unreasonably dangerous because of a production defect, design defect, or both. A product's warnings and documentation are a part of a product's design, and therefore inadequate warnings can be a basis for strict product liability. Assumption of risk, product misuse, and commonly known dangers are all defenses to strict product liability.

? Exercise 8.4.1

1. Is the risk of death from smoking a commonly known danger? It may be today, but in the fifties and sixties, the tobacco industry undertook an extraordinary campaign to convince the public that there was no harm in smoking cigarettes, and even suggested that smoking may have health benefits. See http://tobacco.stanford.edu for a collection of some of the print advertising from this era. Should older plaintiffs who grew up viewing these advertisements be allowed to sue tobacco companies under strict product liability? Why or why not?
2. Is fast food or restaurant food an unreasonably dangerous product? Many nutritionists and doctors believe that excessive consumption of fast food and restaurant food can lead to obesity, high blood pressure, heart disease, diabetes, and other health complications including premature death. You may be surprised at exactly how bad these food products can be for you. See http://www.youtube.com/watch?v=MtgOmChwAm4 for an example of how unhealthy eating out at Italian restaurants can be. Should these food producers therefore take steps to make their product less dangerous or to warn about the dangers of overconsumption? Should Congress pass legislation such as the Personal Responsibility in Food Consumption Act to immunize the food industry from product liability suits?

3. Stella Liebeck, an elderly grandmother, received third-degree burns when she spilled coffee purchased at a McDonald's drive-through. At trial, experts testified that McDonald's coffee was too hot to be consumed at the point of purchase, was hotter than any other restaurant's coffee or coffee brewed at home, and was so hot that third-degree burns would result within three to five seconds of coming into contact with the skin. McDonald's also conceded that the coffee was brewed extremely hot for commercial (profit) reasons, because most customers wanted coffee to be hot throughout their commute. After finding the company liable, the jury awarded Mrs. Liebeck two days' worth of coffee sales at McDonald's, an amount equivalent to $2.7 million, in punitive damages. The award, although reduced to much less than that, set off a firestorm of criticism that has not died down to this day. Do you believe that it's possible for coffee to be unreasonably dangerous? See http://www.hotcoffeethemovie.com for one filmmaker's perspective on this case.

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8.5: Concluding Thoughts

Tort law is continually changing and adapting to societal expectations about the freedoms and interests we expect to protect. Although it has endured for many years, recent debates have sought to recast the viability of tort law in political terms. The Republican Party platform, for example, maintains that the rule of tort trial lawyers threatens America's "global competitiveness, denies Americans access to the quality of justice they deserve, and puts every small business one lawsuit away from bankruptcy."Republican National Committee, "2008 Republican Platform," 2008, www.gop.com/2008Platform/Economy.htm#7 (accessed September 27, 2010). Many businesses see tort lawsuits as a nuisance at best and ruinous at worst, and would like to see them disappear altogether. Consumer rights activists, on the other hand (and often backed by plaintiff lawyer groups), believe that tort lawsuits are the most effective way to keep corporations honest and prevent them from putting profits before safety. This debate has led to several proposals for tort reform among the various states, or by the federal government.

These reforms can take several different forms. One common reform is to impose a statute of repose on product liability claims. These statutes function like a statute of limitations and bar plaintiffs from filing tort claims after a certain period of time has lapsed. For example, in 1994 President Clinton signed the General Aviation Revitalization Act into law, imposing an eighteen-year statute of repose on product liability claims brought against general aviation aircraft manufacturers such as Cessna and Piper. The law allowed these manufacturers to once again launch new light aircraft production in the United States. Another popular tort reform is a cap on punitive damages. President George W. Bush supported a nationwide punitive damage cap of $250,000 for medical malpractice claims, but Congress did not pass any such law. Other reforms call for eliminating defective design as a basis for recovery, barring any claims if a product has been modified by the consumer in any way, and allowing for the state-of-the-art defense (if something was "state of the art" at the time it was produced then no strict liability can apply).

Occasionally Congress passes legislation that provides industry-wide tort lawsuit protection for certain industries. For example, in 2005 President George W. Bush signed the Protection of Lawful Commerce in Arms Act. The law shields firearm manufacturers and dealers from product liability lawsuits for crimes committed with their products. Many industries have tried to obtain this form of industry-wide protection, either from Congress or from judicial rulings. Most recently, drug manufacturers hoped for industry-wide protection by arguing that if the Food and Drug Administration approved drug labels, labeling lawsuits would be preempted by the Constitution. The Supreme Court rejected this argument in 2009. *Wyeth v. Levine*, 555 U.S. ___ (2009), http://www.law.cornell.edu/supct/html/06-1249.ZS.html (accessed October 2, 2010).

In spite of these efforts at tort reform, torts remain an important and viable part of civil law. All businesses, of all sizes and across all industries, must maintain a keen understanding of the duties and responsibilities imposed by tort law. Being able to understand, and even embrace, these duties can help businesses thrive while keeping consumers and customers safe.

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CHAPTER OVERVIEW

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9.1: Introduction- Products Liability

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9.2: Why Products-Liability Law Is Important

Learning Objectives

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

- Understand why products-liability law underwent a revolution in the twentieth century.
- 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.
- Know the names of the modern causes of action for products-liability cases.

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-tech/3200539/new-study-warns-of-cell-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, www.businessweek.com/managing/content/mar2009/ca2009036_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 9.1.



Figure 9: 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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9.3: Warranties

Learning Objectives

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

- Recognize a UCC express warranty and how it is created.
- 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.
- Know that there are other warranties: against infringement and as may arise from usage of the trade.
- 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.”

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 9.2. 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?

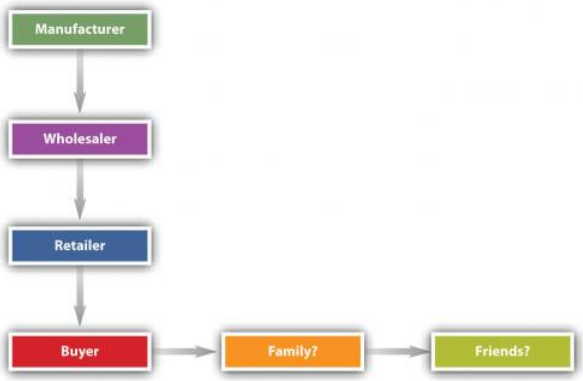


Figure 9.2 Chain of Distribution

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 9.2; 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 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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9.4: Negligence

Learning Objectives

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

- Recognize how the tort theory of negligence may be of use in products-liability suits.
- 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 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 9.3) 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 9.3 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 9.6.3 “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/articles/federal-preemption-products-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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9.5: Strict Liability in Tort

Learning Objectives

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

- Know what "strict products liability" means and how it differs from the other two products-liability theories.
- Understand the basic requirements to prove strict products liability.
- 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 9.4.

	Warranty	Strict Liability
1. Notice of Defect from Buyer to Seller Required?	Yes	No
2. Disclaimer Possible?	Yes	No
3. Privity Required?	Sometimes	No

Figure 9.4 Major Difference between Warranty and Strict Liability

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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9.6: Tort Reform

Learning Objectives

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

- See why tort reform is advocated, why it is opposed, and what interests take each side.
- Understand some of the significant state reforms in the last two decades.
- 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. http://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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9.7: 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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9.8: 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 CHECK QUESTIONS

1. In a products-liability case
    1. only tort theories are typically asserted
    2. both tort and contract theories are typically asserted

3. strict liability is asserted only when negligence is not asserted
4. breach of warranty is not asserted along with strict liability

2. An implied warranty of merchantability
    1. is created by an express warranty
    2. is created by law
    3. is impossible for a seller to disclaim
    4. can be disclaimed by a seller only if the disclaimer is in writing
3. A possible defense to breach of warranty is
    1. lack of privity
    2. absence of an express warranty
    3. disclaimer of implied warranties
    4. all of the above
4. Under the strict liability rule in Restatement, Section 402A, the seller is liable for all injuries resulting from a product
    1. even though all possible care has been exercised
    2. regardless of the lack of a contract with the user
    3. in both of the above situations
    4. in none of the above situations
5. An individual selling her car could be liable
    1. for breaching the implied warranty of merchantability
    2. under the strict liability theory
    3. for breaching the implied warranty of fitness
    4. under two of the above

AnswerS

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

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CHAPTER OVERVIEW

10: Intellectual Property

10.1: Introduction
10.2: Constitutional Roots
10.3: Patents
10.4: Trade Secrets
10.5: Trademarks
10.6: Copyright
10.7: Concluding Thoughts

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10.1: Introduction

Learning Objectives

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

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

The Apple iPhone 4 is the latest model of Apple's do-it-all cell phone. Since its introduction in 2007, the iPhone has redefined the "smartphone" segment of the wireless phone industry and left its competitors scrambling to catch up. Its sleek lines, gorgeous full-color display, built-in GPS navigation and camera, visual voice mail, and Web surfing capability (either over Wi-Fi or 3G phone networks) made it an instant hit, with thousands of consumers lining up for hours to have their chance to buy one. Its revolutionary business model, where thousands of software programmers could write small programs called "apps" and sell them on the App Store through Apple's iTunes software, created a win-win-win business model for everyone who touched the iPhone. For software programmers, it was a win because small, untested, and first-time programmers could "strike it rich" by selling thousands of their apps directly to consumers without having to find a software publisher first. For Apple, it was a win because thousands of talented programmers, not on Apple's payroll, were developing content for their product and enhancing its appeal. Apple also wins because it collects a percentage fee from every app sold on its iTunes store. And finally, consumers win because they have access to all sorts of creative programs to help them do more on their iPhones than simply make a phone call. The business has been a tremendous success for both Apple and AT&T, the exclusive service provider of iPhones in the United States.

There are quite a few companies in the industry that aren't doing as well, from Nokia to Motorola to Sony Ericsson. If they wanted to see how Apple makes the iPhone, all they'd have to do is buy one and then take it apart to see its components (a process known as reverse engineering). Or they could look at the reverse engineering conducted by iSuppli, an independent market intelligence firm.

Hyperlink: iPhone Teardown Analysis

You can see how iSuppli broke down the components in an iPhone 4 by reading this press release:

http://www.isuppli.com/Teardowns-Manufacturing-and-Pricing/News/Pages/iPhone-4-Carries-Bill-of-Materials-of-187-51-According-to-iSuppli.aspx

iSuppli found out that the bill of material (BOM), or the breakdown of each component Apple purchased to assemble into an iPhone, is roughly $187.51. The most expensive components are a $27 16GB flash memory module from Samsung, a $28.50 display module that includes the iPhone's glossy 3.5-inch screen, and a $10 touch screen assembly that includes the touch-sensitive glass on top of the screen.

Apple makes a lot of money selling iPhones. Although the $199 retail price of the 16GB iPhone 4 suggests that Apple makes only about $12 profit per phone, in reality, the "cost" of the iPhone is much higher than $199, since each phone is sold with a two-year contract with AT&T service. Industry analysts estimate that AT&T pays Apple approximately $300 for each iPhone sold with an AT&T plan, in return for Apple agreeing not sell the iPhone through any other phone network.M. G. Siegler, "AT&T iPhone Deal Extended to 2010. Did Apple Mortgage Its Future for a Subsidy?" *Social Beat*, August 1, 2008, digital.venturebeat.com/2008/08/01/att-iphone-deal-extended-to-2010-did-apple-mortgage-its-future-for-a-subsidy (accessed September 27, 2010). The result for Apple is staggering profitability, with a $1.21 billion profit reported in the first three months of 2009, much of which driven by iPhone sales.Jim Dalrymple, "Strong iPhone and iPod Sales Drive Apple Profits to $1.21 Billion,"

Macworld, April 22, 2009, http://www.macworld.com/article/140162/2009/04/appleearnings.html (accessed September 27, 2010). This chart (Figure 9.1.1 "Estimated Revenues of the Top Cell Phone Manufacturers") shows, to scale, how outsized Apple's profits are compared to those of the rest of the industry. Apple's profit margin, at an estimated 40 percent, is nearly double that of its nearest competitor, Research in Motion, maker of the BlackBerry."A Visualized Look at the Estimated Revenues of the Top Cell Phone Manufacturers," *iSmashPhone*, August 11, 2009, www.ismashphone.com/2009/08/a-visualized-look-at-the-estimated-revenues-of-the-top-cell-phone-manufacturers.html (accessed September 27, 2010).

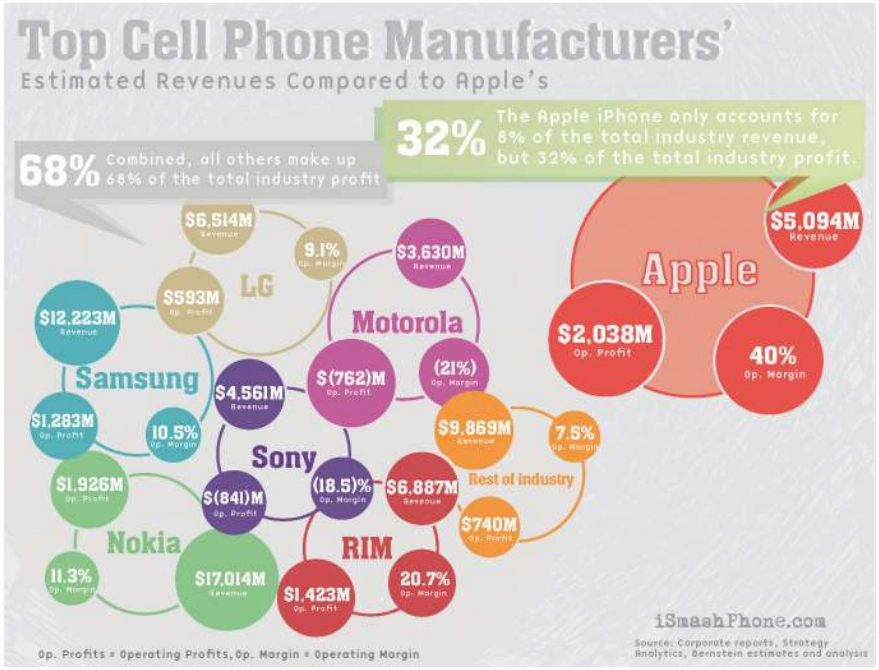


Figure 10.1.1: Estimated Revenues of the Top Cell Phone Manufacturers. Source: Courtesy of iSmashPhone, www.ismashphone.com/2009/08/a-visualized-look-at-the-estimated-revenues-of-the-top-cell-phone-manufacturers.html.

If you were a competitor in the cell phone industry, you'd be sorely tempted to try to duplicate Apple's success. After all, if it only costs $187.51 to make an iPhone, and you could sell it for a $320 profit, why not just make something that looks a lot like an iPhone? Behold the Air Phone No. 4 (Figure 9.1.2 "Air Phone 4"). Released in 2010, the Air Phone is made by a little-known Chinese manufacturer and looks virtually identical to the iPhone 4. It lacks many of the features of the iPhone 4 and does not run on the iPhone's software platform, but at approximately $150 in online stores, it is proving to be a popular alternative to the iPhone.



Figure 10.1.2: Air Phone 4

The reason that companies like Motorola and Nokia don't simply use the bill of material generated by iSuppli to make their own iPhones, of course, is that it's illegal. The BOM only lists the component costs to Apple; it does not capture the amount of money Apple spent in developing the product through the R&D process. The years of software and hardware development that Apple

undertook to create the iPhone involve labor, just as building a skyscraper involves labor. In Apple's case, the product of its labor is not a skyscraper or other tangible property—it is intangible property known broadly as intellectual property, or IP. The law protects Apple's IP just as it protects tangible things from being stolen, so any attempt by a competitor to make an iPhone clone would fail even if the technical ability to do so exists. To be legally sold in the United States, the Air Phone must be different enough from the iPhone that it doesn't actually infringe, or step on, any of Apple's intellectual property rights in the iPhone.

In this chapter, we'll discuss how the law protects IP. We'll begin by examining how IP has been a part of the country's foundation from its very beginning. We'll then discuss the four major types of IP protected by the law: patents, trade secrets, trademarks, and copyright. By the end of this chapter, you'll understand the value that IP plays in a modern economy, the challenges that companies face in doing business in countries that don't value IP, and the devastating impact that IP infringement (including the downloading of music and movies by college students) has on copyright content holders. You'll also be able to distinguish among the various types of IP protection and how they are similar to, and differ from, each other.

Key Takeaways

Companies (such as Apple) invest tremendous resources in developing exciting and innovative new products and services. Reverse engineering means that it would be easy for competitors to quickly figure out how these new products are manufactured, and then copy them. Intellectual property law prevents this from happening and in doing so provides incentive for individuals and companies to create and innovate.

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10.2: Constitutional Roots

Learning Objectives

- Understand the constitutional roots for providing legal protection to intellectual property.
- Explore the tension between content producers and the public good, and how Congress resolves this tension.

Anyone alive when the U.S. Constitution was adopted would be surprised at the size and scope of the U.S. federal government today. What would not surprise them, however, is the existence of the U.S. Patent and Trademark Office (USPTO), since the establishment of a system to protect patents is one of those few congressional powers enumerated in Article I, Section 8 of the Constitution. That clause, known as the Copyright Clause, says that Congress may "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." Keep the keywords of this clause in mind, as we'll come back to them later: "promote progress," "limited times," and "exclusive."

Hyperlink: Patent and Trademark Database

The USPTO Web site is a treasure trove of information as it includes a searchable database for trademarks and patents. See if you can search these databases for well-known trademarks or patents.

http://www.uspto.gov

Although the Constitution addresses only copyrights and patents, modern intellectual property (IP) law also includes trademarks (probably left out of the Constitution because of the relative unimportance of corporations and branding at the time) and trade secrets (a relatively new form of IP protection). Unlike other controversial portions of the Constitution, such as state rights and the role of the judiciary, the value of laws that protected authors and inventors was well accepted in 1787, when inventions of new machines were shaping up to be part of the fabric of the new country. Indeed, the attendees at the Constitutional Convention took a break from their work to watch the first steamship in the Delaware River. One of the first patents granted was to Abraham Lincoln, who drew on his experience as a young man making his way from Indiana to New Orleans along the Ohio and Mississippi rivers on a flatboat to devise a system to lift and drop boats over shallow water without dropping off their cargo. A scale model of his invention is on display at the Smithsonian (Figure 10.2.1). Lincoln, who many historians described as mechanically inclined and fascinated by engineering, felt that the patent system added "fuel of interest to the fire of genius."

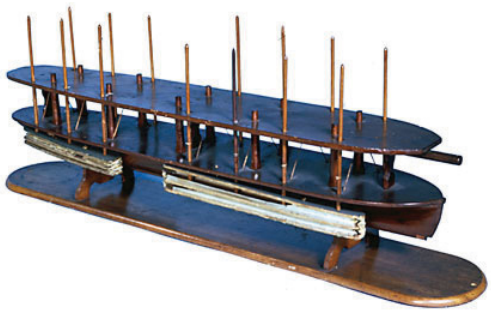


Figure 10.2.1: President Lincoln's Patent. Source: Photo courtesy of the Smithsonian National Museum of American History, http://americanhistory.si.edu/collections/object.cfm?key=35&objkey=19.

Essentially, the Copyright Clause permits (even commands) the federal government to protect certain products of the mind, just as much as it protects personal land or money. If someone trespasses on your property, you can call the police and have them removed or you can sue them in court for damages. In either case, the full force and power of government is involved. The same thing can be said about IP. On the other hand, you know from your economics classes that, in general, our capitalist economy frowns on monopolies. We believe that monopolies are immune from competitive pressures and can, therefore, charge exorbitant prices without any regard to the quality of their product. Efficiency suffers when monopolies are allowed to exist, and ultimately the consumer loses in choice and price. If you think about it, though, the Copyright Clause essentially allows the government to create a special kind of monopoly around IP. Take, for example, a pharmaceutical company that invents a certain kind of drug and applies

for a patent on that drug. If the government grants the patent, then the company can charge as much as it wants (some drugs can cost tens of thousands of dollars per year for consumers) without any regard for competitors, since competitors are shut out of that drug market by virtue of the patent. If any competitor dares to copy the drug to compete against the inventing company, the full force and weight of the government will be brought down on the competitor. Violations of patent law carry extremely stiff penalties.

How can we say that monopolies are bad, and yet grant Constitutional protection to monopolies on IP? The answer lies in the genius of the Copyright Clause itself. As in all monopolies, there are two sides: the producer and the consumer. The producer always wants the monopoly to last as long as possible, while the consumer wants the monopoly to end as quickly as possible. The Copyright Clause strikes a compromise between the producer and the consumer in two ways.

First, the Clause states that Congress can grant the monopoly only to "promote the progress of Science and Useful Arts." In other words, the monopoly exists for a specific purpose. Note that "making Beyoncé rich" or "allowing Pfizer to make billions of dollars" is not the purpose. Rather, the purpose is progress. Granting monopolies can encourage progress by providing a financial incentive to producers. Singers, songwriters, inventors, drug companies, manufacturers—they all invent and innovate in the hope of making money. If they knew that the law wouldn't protect what they came up with, they'd either not invent at all or they'd simply do it for themselves and their families, without sharing the fruits of their labor with the rest of society.

Second, the clause states whatever monopoly Congress grants has to be for a "limited time." In other words, at some point the monopoly will end. When the monopoly ends, science is once again progressed because then society can freely copy and improve upon the producer's products. Society benefits greatly from the expiration of these IP monopolies. Important drugs such as aspirin and penicillin, for example, can now be purchased for pennies and are accessible to the entire human population. Grand literary works, such as Shakespeare's *Hamlet* or Beethoven's Fifth Symphony, can be performed and enjoyed by anyone at any time without seeking permission or paying any fees or royalties. These inventions and works are in the public domain, to be enjoyed by all of us.

The Copyright Clause does not state how long the monopoly can last; it leaves that task to Congress. Congress must make the decision based on what's best to promote progress. Remember, though, that producers want monopolies to last as long as possible. For example, consider how long copyrights last. Since 1976 copyrights have lasted for fifty years after the death of the author. After that, copyrighted works fall into the public domain (such as works by Shakespeare or Beethoven). In 1998, however, Congress began considering adding an extra twenty years to that term, for a total of seventy years after the author's death. In the early part of the twentieth century, the United States experienced a cultural renaissance that accompanied the Industrial Revolution. The invention of the phonograph and cameras allowed the creative genius of Walt Disney, George Gershwin, and Charlie Chaplin (to name a few) to flourish. Under the 1976 copyright law, though, some of these early works (including early versions of Winnie the Pooh) were about to fall into the public domain by 1998. The United States was also under some pressure from international trading partners to increase the copyright term.

Video Clip: United Airlines Commercial

(click to see video)

As a result of these pressures, U.S. Representative Sonny Bono (himself a popular artist together with his former wife Cher) introduced the Copyright Term Extension Act to add twenty years to copyrights. During hearings on this bill, Congress heard testimony from Jack Valenti, then president of the Motion Picture Association of America, an industry group that represents film studios and corporations. When asked how long he thought copyrights should last, he answered "Forever minus a day." Although Sonny Bono's bill passed, whether or not "forever minus a day" will eventually become the law as Congress seeks to strike the right balance between protection and access and whether it satisfies the Constitution's demand that the monopoly last for a "limited" time remain unresolved questions.

Key Takeaways

The Constitution commands Congress to provide monopoly protection for intellectual property, but only for purposes of progressing science and useful arts, and only for a limited time. Content producers will always want legal protection to last as long

as possible to maximize profits, while the public good benefits when content falls into the public domain. Congress is under intense pressure to resolve this tension.

? Exercise 10.2.1

1. Why do you think the Founding Fathers decided to empower Congress to protect intellectual property, but only for a limited time?
2. How likely do you think it is that Congress may extend the term for copyright protection again in the future? Why?

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10.3: Patents

Learning Objectives

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

Imagine that you invented the Apple iPhone 4. If you invent a patentable item that is useful, new, and nonobvious, and if you are capable of describing it in clear and definite terms, you may wish to protect your invention by obtaining a patent. A patent grants property rights to the inventor for a specified period of time, with a utility patent and a plant patent expiring twenty years following the original patent application and a design patent expiring fourteen years afterward. A patentee owns a patent.

However, if you invented the Apple iPhone 4 while employed to perform creative and inventive work, then any patents obtained with respect to your work would be assigned to your employer. Many inventors and designers work for employers in creative and inventive capacities. This arrangement allows innovative ideas to be adequately funded in trade for the property rights resulting from patents granted to those inventions.

Three patent types exist. Utility patents may be granted for machines, processes, articles of manufacture, compositions of matter, or for improvements to any of those items. The Apple iPhone 4 certainly is the subject of utility patents. A design patent may be granted for ornamental designs for an article of manufacture. A plant patent covers inventions or discoveries of asexually reproduced plants (e.g., plants produced through methods such as grafting).

Not all items are patentable. For instance, an idea alone (without a definite description) cannot be patented. So even if you dreamed up the idea of something that looked and functioned exactly like the Apple iPhone 4, you would not have been eligible for a patent on your idea alone. Likewise, physical phenomena, the laws of nature, abstract ideas, and artistic works cannot be patented. Note, however, that artistic works can be copyright protected. Additionally, otherwise patentable subjects that are not useful, or items that are offensive to public morality, are not patentable.

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

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

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

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

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

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

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

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

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

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

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

In the last decade, there has been an over 400 percent increase in the number of patents filed, resulting in a multiyear delay in processing applications. An increase in the number of business method patents contributed to this dramatic increase in patent applications. A business method patent seeks to monopolize a new way of conducting a business process. Figure 10.3.1, for example, describes a method of e-commerce by which a customer can order an item and pay for it immediately with just one click of a mouse button. This one-click patent was granted to Amazon.com, much to the chagrin of other online retailers such as Barnes & Noble, who were prohibited from using a similar checkout mechanism. Amazon licensed the patent to Apple so that it could feature one-click on its Web site.

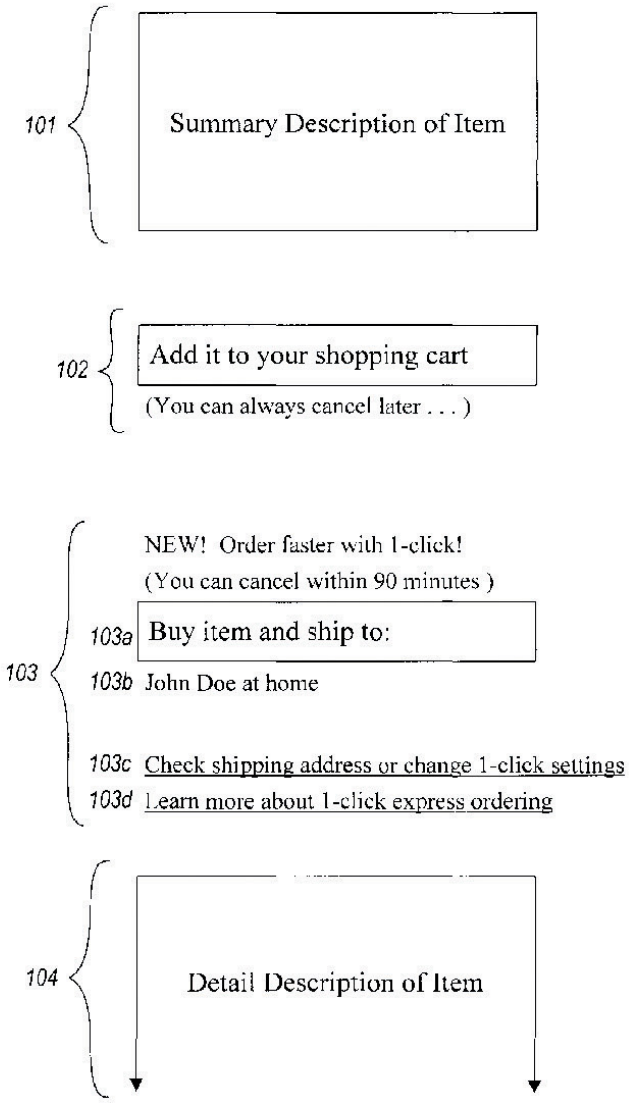


Fig. 1A

Figure 10.3.1: Patent Filing for One-Click Web Ordering. Source: Courtesy of Free Software Magazine, http://www.freesoftwaremagazine.com/files/www.freesoftwaremagazine.com/nodes/1250/1A.jpg.

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

claim. A successful action may result in an injunction, treble damages, costs, and attorney's fees. One defense to a patent infringement claim is to challenge the validity of the patent.

Hyperlink: Wal-Mart Tries to Produce Shoes

Nike recently sued Wal-Mart stores for selling a shoe that Nike claims infringes on its patents. The shoe sold by Wal-Mart uses technology similar to Nike's Shox technology. Look at Nike's complaint here: http://online.wsj.com/public/resources/documents/nikepatentsuit.pdf

Do you think that Nike has a good claim? What should Wal-Mart's defense be?

In recent years several companies that do nothing but sue other companies for patent infringement have emerged. These patent-holding companies, sometimes called patent trolls by critics, specialize in purchasing patents from companies that are no longer interested in owning them and then finding potential infringers. One such company, NTP, sued Research in Motion (RIM), the maker of the BlackBerry device, for a key technology used to deliver the BlackBerry's push e-mail feature. Faced with a potential shutdown of the service, RIM decided to settle the case for more than six hundred million dollars.

Exercise 10.3.1

1. Do you think that life forms should be the subjects of patents? Does your answer change depending on whether we are talking about bacteria, plants, animals, or humans? What are the most persuasive arguments in favor of, and against, allowing the patentability of higher life forms?
2. How do patent rights encourage innovation?
3. If patents are protected monopolies, why do you think patent applications are a matter of public record?
4. Do you agree with compulsory licensing of life-saving medications in response to national health emergencies? What are the consequences of compulsory licensing to the patentee? To the people in need of these medications in wealthy countries? To the people in need of these medications in poor countries?

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10.4: Trade Secrets

Learning Objectives

- Understand what a trade secret is.
- Learn the differences between trade secret and patent protection.
- Learn how trade secrets may be lawfully discovered.
- Explore the concept of misappropriation and the legal consequences.

Imagine that you are in an antique store and find a nineteenth-century ledger book for sale, originally from the W. B. Morrison & Co. Old Corner Drug Store in Waco, Texas. Among the recipes for hair restorers and cough syrups, something in particular catches your eye—a recipe entitled *D Peppers Pepsin Bitters*. What if you also knew that Dr. Pepper was first created and served in that very drugstore? What if you offered to pay two hundred dollars for the old ledger book, even though if it did contain the recipe for Dr. Pepper, it would be worth far more? After all, according to the company that manufactures Dr. Pepper, only three people know the recipe to that very closely guarded trade secret. Something very similar to this happened to Bill Waters. He found the ledger book in an antique store, and he paid two hundred dollars for it. However, at the time, he did not know that the book might date back to the exact time and place from which the popular soda was created. In fact, he did not even notice the recipe until later, and it took him several more days to recognize the possibility that it might be an early version of Dr. Pepper.



Figure 10.4.1: Dr. Pepper Bottle. Source: http://en.Wikipedia.org/wiki/File:Dr_Pepper_bottle.JPG.

Unlike patents, a trade secret can last forever. That is, it can last forever if the owner of the secret can, well, keep it a secret. If someone uses lawful means to uncover the secret, then the secret is no longer protected by the secret's owners. Does this include reverse engineering? Yes. Reverse engineering is an absolutely legal means of discovering a trade secret. What about ferreting out secrets from an employer's safekeeping, while employed and under a binding confidentiality agreement? No. That is an actionable claim for misappropriation, and the secret's owners can pursue damages.

Trade secrets are unlike patents in another important way. With a patent, the inventor must specifically disclose the details of the invention when applying for a patent. This means that the inventor has not protected the secret of the invention. However, in exchange for this disclosure, a patent owner has a legal monopoly over the property for a specified period of time. So even if others discover the secret of the invention (not a difficult task since patent applications are public record), they are prohibited from making, using, or selling it without the patentee's permission. After the patent expires, then the patentee no longer has a property right to exclude others.

So what is a trade secret? It is, in short, secret information. This information may include a process, formula, pattern, program, device, method, technique, or compilation. For many companies, lists of suppliers, costs, margins, and customers are all trade secrets. Soft drink recipes, KFC's eleven spices, the donut mix sent to Krispy Kreme franchisees, the Big Mac's special sauce, and even the combination of wood that is used in the burning process to make Budweiser beer are all trade secrets. Additionally, the information derives actual or potential economic value from being a secret that is not readily discoverable by others, and the information is the subject of efforts to keep it a secret. While most states have adopted the Uniform Trade Secrets Act (UTSA), not all have, so the definition of trade secret can vary by jurisdiction. Unlike patents, trademarks, and copyrights, there is no federal law protecting trade secrets.

A claim for misappropriation may be brought when a trade secret has been wrongfully obtained, such as through corporate espionage or bribery. Generally, according to the UTSA, misappropriation occurs if the secret was acquired by improper means, or if the secret was disclosed or used without permission from the secret's owner. Damages may include actual loss and unjust enrichment not captured by actual loss. Additionally, in cases of willful or malicious misappropriation, double damages may be awarded, as well as attorney's fees.

So what if you are never lucky enough to discover a multimillion-dollar secret recipe hidden away in an antique shop? As long as the recipe is not patented, you can try to reverse engineer it. If you succeed, you can use it immediately. However, if you are working for an employer in a creative capacity, working with others to develop the secret, and if you have agreed not to use trade secrets, then the right to the trade secret will belong to your employer, at least in most jurisdictions. Ask Peter Taborsky, an undergraduate student at South Florida University in 1988. According to Taborsky, while working in the university's chemical engineering lab, he began conducting experiments on his own. He discovered a highly effective method for treating sewage. The university demanded that he hand over his notebooks that contained the secrets of this invention. Taborsky refused and filed for a patent for his invention, which he received. However, the university pressed criminal charges for stealing trade secrets. Taborsky lost his case and found himself in a maximum-security facility working on a chain gang.

So does Bill Waters need to worry about Dr. Pepper's owners suing him for misappropriation or pressing criminal charges for stealing trade secrets? No. He lawfully obtained the ledger book by purchasing it in the open market. Additionally, according to a company spokesman, the ingredient list under *D Peppers Pepsin Bitters* is most likely an old remedy for a stomachache rather than any version of the recipe for Dr. Pepper. Even if Mr. Waters had accidentally stumbled on the exact Dr. Pepper recipe, he would have a good argument that the company did not take steps to keep the secret a secret. If it had, he could argue, the company never would have allowed the recipe out of its sight.

Key Takeaways

Trade secrets last forever if the owner of the secret keeps the secret. However, if someone else discovers the secret through a lawful method, then the owner of the secret has no right to exclude others from using the secret. Unlawfully obtaining a trade secret is called misappropriation, which is an actionable claim. The Uniform Trade Secret Act has been adopted by most (but not all) states, so different jurisdictions have different rules of law concerning trade secrets.

? Exercise 10.4.1

1. If you owned a trade secret, what methods would you employ to protect it?
2. If you invented something that was patentable or the subject of a trade secret, what types of issues would you consider when deciding whether or not to apply for a patent?

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10.5: Trademarks

Learning Objectives

- Understand what a trademark is.
- Learn what can and cannot be trademarked.
- Explore how companies protect trademarks from dilution and genericide.
- Examine how the Internet poses new challenges to trademark owners.
- Explore the tension between trademark protection and free speech.

Look at Figure 9.5.1 "McDonald's, One of the Most Recognized Trademarks in the World". It's obviously a McDonald's restaurant, but can you tell where this restaurant is? Is it in a mall or airport? Is it in Trenton, Toronto, or Tokyo (or, as it turns out, Messestadt Riem in Germany)? Without additional information, it may be impossible to tell. And yet, no matter where you are in the world, if you enter this McDonald's restaurant, there are certain standards that you expect. You would expect to find a Big Mac on the menu, perhaps Chicken McNuggets and french fries too. You would expect those menu items to taste the same as they do in your local McDonald's. Perhaps you'd expect a certain level of service from the employees, a certain value proposition for your money, a certain look from the uniform and fixtures, or perhaps a clean restroom. If you walked into this McDonald's restaurant and found out that it was in fact not McDonald's, you might be confused. The ultimate goal of trademark law is to prevent this consumer confusion. To prevent any other restaurant from using the name McDonald's, or from using a logo that looks like a stylized "M," McDonald's can trademark both its name and logo (and a lot of other elements of its brand as well). In this section, we'll examine how trademark law accomplishes this goal.



Figure 10.5.1: McDonald's, One of the Most Recognized Trademarks in the World. Source: commons.wikimedia.org/wiki/File:RiemArcaden.McD.JPG.

A trademark is any kind of name, logo, motto, device, sound, color, or look that identifies the origin of a particular good or service. Something begins to look like a trademark when a consumer *identifies* it with a particular origin. For example, someone buying a Diet Coke knows that he or she is getting a carbonated beverage from the Coca-Cola Company. If he or she bought a Diet Cola, on the other hand, there's no association in the mind with any particular company, so it could be from Coca-Cola, Pepsi, or any number of other companies. The key is that consumer identification with a specific origin. If a consumer thinks of a class of goods rather than one specific origin, then it's not a trademark. So, for example, when a consumer hears "aspirin," he or she thinks of a class of goods with no particular origin because aspirin is not a trademark. But if a consumer hears "Bayer," he or she thinks of a specific aspirin from a specific source, making "Bayer" a trademark.

Hyperlink

www.uspto.gov/go/kids/kidsound.html

Can sounds be trademarked? Yes! Some sounds are instantly recognizable, such as AOL's "You've Got Mail" and Twentieth Century Fox's movie opening scene. Click the link to explore other trademarked sounds.

A federal law, the Lanham Act, protects trademarks. Unlike copyrights and patents, trademarks can last forever and are not subject to the Constitution's "limited time" restriction. Since the objective of trademark law is to prevent consumer confusion, the public good is best served by allowing companies to maintain their trademarks as long as consumers associate a trademark with a specific origin. The moment they no longer make that association, however, the trademark ceases to exist.

If you are considering marketing as a career, you will become intimately familiar with the concepts related to branding and the value of branding. At its core, marketing involves the science of relating to consumers, telling them an authentic story about your product and service, and satisfying their wants and needs. Having a brand is essential to carrying out this objective, and it can lead to startling profits. The Apple and iPhone brands, for example, are very strong and yield billions of dollars in profits for Apple. Luxury brands are particularly aware of this phenomenon, as often their brand alone can justify pricing far above a similar good. Gucci, such as this store in Hong Kong (Figure 9.5.2 "Gucci Store in Hong Kong"), trades on the value of its brand to command premium prices (and margins) in the marketplace. Brands such as Rolex, Hermes, Rolls-Royce, and Bentley have similar business models. These brands are all trademarks—indeed, all brands are either registered trademarks or are trademark-able because they share the common feature of consumer identification. Be careful, though. "Trademark" and "brand" are not interchangeable terms because not all trademarks are brands.



Figure 10.5.2: Gucci Store in Hong Kong. Trademark law is especially important for luxury brands such as Gucci. Source: Photo courtesy of Maizeam, commons.wikimedia.org/wiki/File:HK_TST_Canton_Road_GUCCI_Shop.JPG.

So what can be a trademark? Obviously, words can be trademarked. When it comes to trademarks, distinctiveness is good. Therefore, an invented word is the best type of trademark. In 1997, for example, when Stanford grad students Larry Page and Sergey Brin were brainstorming names for their new Internet search engine, they settled on the word "Google," a play on "googol," which means 1 followed by 100 zeroes. They felt the name reflected their goal to organize the staggering amount of information available on the Internet. On the other hand, regular words can also become trademarks, as long as consumers identify them with a particular source. Amazon, for example, is the name of the world's longest river, but it's also the name of an online retailer. Since

consumers now identify Amazon.com as an online retailer, the name can be trademarked. Another example is the phrase “You’re Fired” when used in a television program. The phrase was made popular by billionaire Donald Trump and has such lasting recognition now that it’s unlikely any other television show could use that phrase as a central part of its theme.

Consider what would happen if you tried to trademark your name. If your name happens to be Sam Smith, you’d probably have a pretty hard time getting a trademark for your name. If, however, you called your business Sam Smith anyway and started growing your business so that eventually, over time, consumers began to identify “Sam Smith” as your business, then your name has acquired a secondary meaning and can be trademarked. Thus, Sam Adams is a trademark for a beer, Ben & Jerry’s is a trademark for ice cream, and Ford is a trademark for a motor vehicle.

Hyperlink

http://www.npr.org/templates/story/story.php?storyId=19227066

Can a sportscaster trademark the phrase “Are you ready to rumble”? Can Paris Hilton trademark the phrase “That’s hot”? As long as the public associates these phrases with a distinctive origin, the answer is yes. Listen to this National Public Radio broadcast for more examples.

Note that when you get a trademark, it’s typically granted for a specific category of goods. The same name can sometimes be used for multiple categories of goods. The name Delta, for example, is a trademark for both an airline and a brand of faucets. Since there is little chance that a consumer will be confused by an airline or faucet brand, trademark law allows these dual registrations. On the other hand, some brands are so strong that they would probably stop registration even for a completely different category of goods. McDonald’s is a good example of this. The McDonald’s trademark is one of the strongest in the world, meaning that it is instantly recognizable. In 1988, for example, hotel chain Quality Inns decided to launch a new line of budget motels called “McSleep.” McDonald’s sued, claiming trademark infringement. McDonald’s claimed that consumers might be confused and believe that McDonald’s owned the hotel chain. A federal judge agreed and ordered Quality Inns to change the name of the chain, which it did, to Sleep Inns.

Trademarks go beyond simply a company’s name or its logo. A color can be trademarked if it’s strong enough to create consumer identification. Pink, for example, is trademarked when used for building insulation by Owens Corning. All other insulation manufacturers must use different colors. Sounds can be trademarked too, such as MGM Studios’ “lion’s roar.” Even a certain “look” can be trademarked if a consumer identifies it with a certain origin. Thus, the distinctive colors, materials, textures, and signage of a Starbucks or T.G.I. Friday’s are considered trade dress and cannot be copied. A bottle shape can be considered trade dress, too, such as the shape of a nail polish bottle (Figure 9.5.3 "OPI’s Nail Polish Bottle"). OPI, a nail polish manufacturer, has registered this bottle shape with the U.S. Patent and Trademark Office (USPTO) and is suing other manufacturers that use a similarly designed bottle. Interestingly, courts have been reluctant to grant certain smells trademark protection, even though it can be argued that certain fragrances such as Old Spice or CK One are distinctive. Imagine the chaos that would ensue if one company claimed trademark protection for vanilla or strawberry scents—consumers would ultimately be robbed of choice if that were to happen.

A trademark is not limited to a name or logo used to sell goods. If a company provides a service (as opposed to selling goods), it too can receive trademark protection. In this case, it’s called a service mark. Facebook, for example, is a service mark. A trademark can also be used to demonstrate certification meeting certain standards, such as the Good Housekeeping Seal of Approval. If you study operations management, you’ll learn about the International Organization for Standardization (ISO) and its various standards for quality management (ISO 9000) or environmental quality (ISO 14000). The Forest Stewardship Council (FSC) allows its logo to be used on paper products that come from sustainable forests, while certain foods can be labeled “Organic” or “Fair Trade” if they meet certain standards as established by governmental or nongovernmental organizations. Each of these marks is an example of a certification mark. Finally, a mark can represent membership in an organization, such as the National Football League, Girl Scouts of America, Chartered Financial Analyst, or Realtor (Figure 9.5.4 "“Realtor” Certification Mark"). Each of these is known as a collective mark. The rules that apply to trademarks apply equally to service marks, collective marks, and certification marks.


O·P·I
NAIL
LACQUER



Figure 10.5.3: OPI's Nail Polish Bottle. A bottle's shape can be trademarked if it is distinctive enough. Source: Photo courtesy Jessica Ta, http://www.flickr.com/photos/bloggles/4288368487.

If a color or sound can be trademarked, is there anything that cannot be trademarked? The Lanham Act excludes a few categories from trademark registration, mainly for public policy purposes. Obviously, trademarks will not be granted if they are similar or identical to a trademark already granted. If you're starting a new company, it's a good idea to make sure that not only is a domain name available for your company's name, but that the name isn't already trademarked by someone else. Trademarks also cannot contain the U.S. flag, any government symbol (such as the White House or Capitol buildings), or anything immoral. Trademarks cannot be merely descriptive. (Thus every restaurant is allowed to offer a "Kid's Meal," but only McDonald's can offer a "Happy Meal.")



Figure 10.5.4: "Realtor" Certification Mark. Source: upload.wikimedia.org/Wikipedia/en/1/16/Realtor_logo.jpg.

Whether or not a region can be trademarked (a geographic indicator, or GI) is the subject of some controversy, especially with our trading partners. "Maine Lobster," "Napa Valley Wine," or "Florida Orange Juice," for example, may indicate to some consumers the origin of a particular lobster or bottle of wine or orange juice, and thus may be of commercial value to distinguish the product from competitors from other regions. For the time being, these foods must come from Maine, California, or Florida to avoid liability under consumer protection statutes for fraud (lying) about their origin. What happens, though, if consumers lose the association with the region? For years, sparkling wine manufacturers in Champagne, France, have fought to prevent this from happening by requiring that only sparkling wine made in the Champagne region be called "champagne." Now, food producers (especially in the European Union) are seeking similar protection under international trademark law for Feta, Parmesan, Gorgonzola, Asiago, and hundreds of other names.

A trademark is valid as long as consumers believe that the mark is associated with a specific producer or origin. If the mark refers to a class of goods instead, then the trademark can no longer exist. This process is called genericide. Many words today once started as trademarks: furnace, aspirin, escalator, thermos, asphalt, zipper, softsoap, cellophane, lite beer, Q-tip, and yo-yo are all examples of trademarks that are now generic and have therefore lost legal protection. To prevent genericide from occurring, trademark owners must take active steps, often costing millions of dollars, to educate consumers on the importance of using their trademarks properly and to prosecute infringers. For example, when you hear the word "Kleenex," do you think of a brand of tissue owned by Kimberly-Clark, or do you think of tissues generally? Does "Rollerblade" refer to a brand of in-line skates, or to all in-line skates? In Southern states, does "Coke" refer to a Coca-Cola, or to soft drinks generally? When you run a "Xerox" photocopy, is it on a Xerox photocopier or some other machine? These trademarks, all currently active and worth billions of dollars to their owners, are in danger of becoming generic in the United States. If that happens, the companies will lose control of the marks and the public (and competitors) will be free to use those words just as they use "aspirin" and "yo-yo" today. Xerox has taken many steps to educate the public about its trademark, including running print advertisements in business periodicals. In one of these ads, the text says, "When you use 'Xerox' the way you use 'aspirin,' we get a headache."

Trademark infringement occurs when someone uses someone else's mark, either completely or to a substantial degree, when marketing goods or services, without the permission of the mark's owner. Obviously, making your own pair of jeans and slapping a

“Levi’s” label on it, or making your own handbag and sewing a “Coach” label on it, constitutes trademark infringement. When Apple first released the iPhone, to its embarrassment it found out that “iPhone” was already a registered trademark belonging to Cisco, another company, for a phone used for placing phone calls over the Internet. To avoid trademark infringement liability, Apple had to pay Cisco an undisclosed sum to purchase the trademark. Ford found itself in a similar situation when it released a supercar called the “Ford GT.” Ford made a similar racing car in the 1960s called the “GT 40” but lost control of the trademark after production ceased. Unable to reach agreement with the current trademark owners, Ford settled for releasing the new car as simply the “GT.”

The law also permits trademark owners to sue infringers who use their marks to a substantial degree. For example, when Samsung announced its new smart phone, the Black Jack, the makers of the BlackBerry device sued for trademark infringement. When a software company released a product to eliminate unwanted e-mails called “Spam Arrest,” it was sued by Hormel, makers of Spam canned luncheon meat. When a small coffee shop in Syracuse, New York, opened as “Federal Espresso,” the shipping company FedEx filed a trademark infringement claim.

Even if a trademark owner doesn’t believe a similar use of its mark would lead to any consumer confusion, it can protect its trademark through a concept called dilution. Such was the case when an adult novelty store in Kentucky opened as “Victor’s Secret” (the owner’s name was Victor). The trademark owners of “Victoria’s Secret” filed a dilution suit in response. Traditionally, trademarks are intended to prevent consumer confusion. Dilution permits a trademark owner to stop usage of a similar word or phrase even if consumers aren’t confused. Under dilution concepts, the trademark owner only needs to show that its mark will be diluted or tarnished in some way.

Dilution is controversial in trademark law. When Congress passed the first dilution law in 1995, the Federal Trademark Dilution Act, many felt that Congress had gone too far in protecting trademarks, to the detriment of the public and small businesses. For one thing, the Act only protected “famous” trademarks. It also failed to clearly define “dilution,” and what was required for trademark owners to win a lawsuit. Finally, when the Victor’s Secret case reached the Supreme Court, *Moseley v. Secret Catalogue*, 537 U.S. 418 (2003)[0].[0] the Supreme Court issued some clarification. The Court ruled that to win a dilution case, a trademark owner had to show that it had suffered actual economic damage from the dilution, not merely the “likelihood” of dilution. This is a high standard for trademark owners to meet, because it means that they (1) have to wait for the diluting mark to hit the market and be used in commerce and (2) must be able to prove that they suffered economic damage from the diluting mark. Unhappy with the Court’s decision, corporations lobbied Congress to pass the Trademark Revision Dilution Act of 2006, which overturns the Moseley case. Now, trademark owners of famous trademarks only need to show a likelihood of dilution before filing a dilution lawsuit.

Companies or persons accused of trademark infringement have several defenses to rely on. The most obvious is arguing that no infringement has occurred because the two marks are sufficiently different that consumers won’t be misled. For example, in 2002 Jeep sued General Motors for infringing on what Jeep called its trademark grill. GM’s Hummer division released the H2 that year, with a similar seven-bar grill. A district court held that there was no trademark infringement because the grills were too dissimilar to cause consumer confusion. Look at the Hummer H2 grill (Figure 9.5.5 "Hummer H2 Grill") and the Jeep grill (Figure 9.5.6 "Jeep Grill"). Do you think there is a chance of consumer confusion?



Figure 10.5.5: Hummer H2 Grill. Source: Photo courtesy of Ramchandran Maharajapuram, http://www.flickr.com/photos/me_ram/3157719487.



Figure 10.5.6: Jeep Grill. Source: Photo courtesy of 3obryans, www.flickr.com/photos/3obryans/1017233.

Another defense is fair use. The Lanham Act prohibits the use of someone else's trademark when selling goods. It's not uncommon to see various items such as laptop computers, telephones, soda cans, or other foods with their labels covered by stickers or blurred out on television shows and movies because of the trademark law. On the other hand, what if a company wanted to mention a competitor's product to draw a comparison with its own product? This is called comparative advertising, and it's considered fair use. Honda, therefore, is free to claim that its "Honda Accord is better than the Ford Taurus" in its advertising even though Ford and Taurus are both trademarks owned by Ford Motor Company.

The First Amendment also recognizes the use of parody, comedy, or satire as fair use. Comedy skits on television that make fun of, or use, company logos are an example of this fair use. Canadian nonprofit Adbusters, for example, claims to be an organization seeking to advance "a new social activist movement in the information age." Part of its work involves making fun of corporations and consumer spending, sponsoring "Buy Nothing Day" as an antidote to the annual holiday spending season. Making fun of corporations also involves spoofing their commercial messages, as the ad in Figure 9.5.7 "A Parody of the Well-Known Absolut Vodka Print Ads" illustrates. Although the ad undoubtedly infringes on a trademark, it is considered fair use because of the social commentary and satire behind its message.

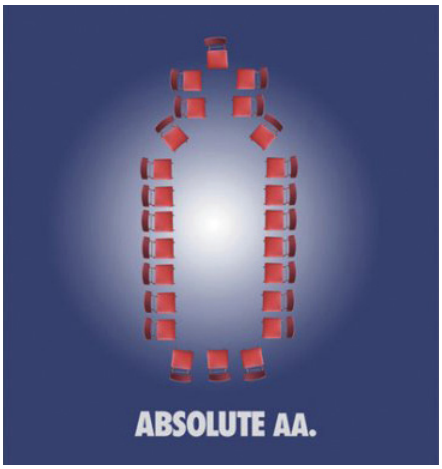


Figure 10.5.7: A Parody of the Well-Known Absolut Vodka Print Ads. Source: Photo courtesy of Adbusters, www.adbusters.org/gallery/spoofads/alcohol/absolutaa.

An interesting aspect of trademark infringement arises through the use of domain names on the Internet. The practice of cybersquatting (or domain name squatting) arises when a company registers a domain name containing a famous trademark in hopes of selling that trademark to its rightful owner for a large profit. The practice arose in the early days of the Internet, when domain name registration took place on a first-come, first-served basis. There is nothing wrong with registering a domain name for a generic word such as "shoes.com," but incorporating a registered trademark into the domain name, for purposes of selling it later, is considered cybersquatting. This practice was made illegal in 1999 with the passage of the Anticybersquatting Consumer Protection Act. It is only illegal, however, if the domain name is registered to make a profit through later sale. It is not illegal if someone registers the domain name in "good faith." A good example is the domain name registered by Canadian teenager Mike Rowe in 2003. An avid computer user, he registered "mikerowesoft.com" as a domain name. Software giant Microsoft launched legal proceedings against him, claiming violation of the cybersquatting statute and trademark infringement. Rowe's defense was that the Web site merely reflected his name and his interest in computer programming and software and was being used for that purpose. After heavy negative publicity, Rowe and Microsoft settled the case with Microsoft taking control of the domain. Another example surrounds the Nissan.com domain. Uzi Nissan, a computer storeowner, had owned the domain for years before Nissan Motors attempted to gain ownership of the domain. Since the domain was registered in good faith, no cybersquatting has occurred. The First Amendment is also a defense to cybersquatting. Web sites run by consumer activists who seek to criticize or parody companies, such as "fordreallysucks.com" or "fordlemon.com" or "peopleofwalmart.com" are not cybersquatting in spite of their use of trademarks.

Key Takeaways

Trademarks are anything that identifies the unique origin or goods or services. Trademarks are granted under federal law by the U.S Patent and Trademark Office and can last forever. When a trademark is no longer associated with a specific origin, it becomes generic and loses legal protection. Trademark owners can take legal action against infringement and dilution of their marks. Fair use of trademarks includes comparative advertising and parody. Trademark protection extends to the Internet, where mark owners can prevent bad faith domain name squatting.

? Exercise 10.5.1

1. Go to the U.S. Patent and Trademark Office at http://www.uspto.gov. Search the trademark database for the phrase "Let's Roll." Do you think that companies should be able to trademark phrases? Can you find other examples?
2. "Netbook" is an example of a term the USPTO recently rejected as being generic, even though it was at one point a registered trademark. Can you think of other recent examples of genericized trademarks?
3. Do you think that the rules of cybersquatting should extend beyond Internet domain names to other uses such as Facebook or Twitter account names? Why or why not?

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10.6: Copyright

Learning Objectives

- Understand what a copyright is.
- Explore the requirements for copyright protection.
- Learn how copyright owners can license their works for use by others.
- Understand copyright infringement and the fair use defense.
- Understand the Digital Millennium Copyright Act.

The final form of intellectual property (IP) protection is copyright. Like patents and trademarks, federal law protects copyright. Whereas trade secrets protect confidential company information, patents protect processes and inventions, and trademarks protect brands and identity, copyright is designed to protect creativity. It is one of the two types of IP specifically mentioned in the Copyright Clause of the U.S. Constitution. Of course, back then the only works copyrighted would have been songs, art, or works in writing. Today, copyright extends to any form of creative expression, including digital forms.

If asked to write down four numbers from one to fifty in random sequence, most of us would write four different numbers. The process of picking those numbers requires creativity, so the sequence of the four numbers you write down is copyrighted. Note that the numbers themselves aren't copyrighted, of course. It's just the unique sequence that you choose, the expression of your creativity, that is copyrighted. Since computer software is a compilation of binary code expressed in 1 and 0, all software is copyrighted. On the other hand, sequential page numbers or listings in a phone directory show no creativity and are therefore not copyrightable. Similarly, if a group of students were given a camera and each was asked to photograph the same subject, each student would come up with a different photograph. Each student would frame the subject differently, and that is an expression of creativity. Finally, consider the notes that you take in class for this course. A group of students could read the same textbook and listen to the same lecture, and come up with different sets of notes. Each work is unique and demonstrates creativity, so each is copyrighted.

A work must be original (not copied) and fixed in a durable medium to be copyrighted. Therefore, if you sing an original song in the shower in the morning and your roommate hears it and records it, the copyright to the song belongs to your roommate, not you. This requirement exists because it would be impossible to prove, without a durable medium, who is the original author of a work. Ideas, by themselves, cannot be copyrighted. If you had an idea for a novel about a boy wizard who goes to a boarding school with his friends and battles evil monsters while growing up, that would not be copyrighted. If you wrote a novel featuring such a story line, however, you would run the risk of violating the copyrighted Harry Potter works. A similar dispute arose in 2006 after the blockbuster success of Dan Brown's novel, "The Da Vinci Code." Two authors, Michael Baigent and Richard Leigh, claimed the novel infringed on their copyrighted book, "Holy Blood Holy Grail." In their book, the authors theorized that Jesus survived his crucifixion, married Mary Magdalene, and had children. The British judge hearing the case dismissed the claims, holding that the theory was "too general or too low a level of abstraction to be capable of protection by copyright law."*Baigent v. Random House Group*, http://www.scribd.com/doc/2473519/da-vinci-code-ruling-baigent-v-rhg-0406 (accessed October 2, 2010).

A copyrighted work is automatically copyrighted upon its creation. Unlike patents and trademarks, which must go through an expensive and rigorous application and approval process with the government, authors do not need to send their work to the government for approval. Although it's a good idea to write "Copyright" or place a © symbol on the work, it's not legally required.

Copyright protection lasts for seventy years after the death of the author. If there is more than one author, the copyright expires seventy years after the death of the last surviving author. If a company, such as a publisher, owns a copyrighted work, the copyright expires ninety-five years from the date of publication, or one hundred twenty years from the date of creation, whichever comes first. After copyright expires, the work falls into the public domain. The works of Shakespeare, Bach, and Beethoven, for example, are in the public domain. They may be freely recorded, performed, or modified without permission. If you were to record yourself reciting Shakespeare's "To be or not to be" speech from *Hamlet*, however, that recording is copyrighted even though the underlying work (*Hamlet*) is in the public domain as a new creative expression. Classical music recordings are similarly copyrighted under the same concept.

The owner of a copyright may allow members of the public to view or use a copyrighted work, for free or for a fee. This use is contained in a copyright license, sometimes called an End User License Agreement (EULA) for software. A license is essentially permission from the copyright holder to violate the copyright, within the terms of the license. When you purchase a physical book or CD or DVD, for example, the copyright license allows you to view the movie, listen to the music, or read the book, in private. The license does not allow you to show the movie in class to a broad audience, or to record the music into your computer and then modify it, or to run photocopies of the book to give away or sell. These rights of reproduction, exhibition, and sale are not part of the license you received and are reserved by the copyright holder. Of course, you may purchase those rights if you wish, but they will probably cost a lot more than the price of the book or disc. Some organizations advocate the creation of a common license that authors can easily refer to if they wish to distribute their work easily. The General Public License (GPL) for software and Creative Commons (CC) license for text and media are well-known examples. One right that you do have, however, in spite of any language in the license, is the right of first sale. Essentially this means that as the owner of the physical work, you can do with it as you please, including resell the original work.

Licenses in the digital arena can be very restrictive if you purchase digital media. Copyright holders may use schemes such as Digital Rights Management (DRM) to limit your ownership rights in digital media. DRM limits the number of copies and devices a digital file can be transferred to, and in some cases even permits the copyright holder to delete the purchased work. Amazon.com recently deleted digital George Orwell books from owners who had purchased the works for their Kindle reading devices (Figure 9.6.1 "Amazon’s Kindle E-reader"), without any prior notification. This would have been impossible if the books were in a physical form. Although Amazon.com was within its rights to do so, the public outcry that followed made Amazon.com promise to not engage in such behavior again in the future.

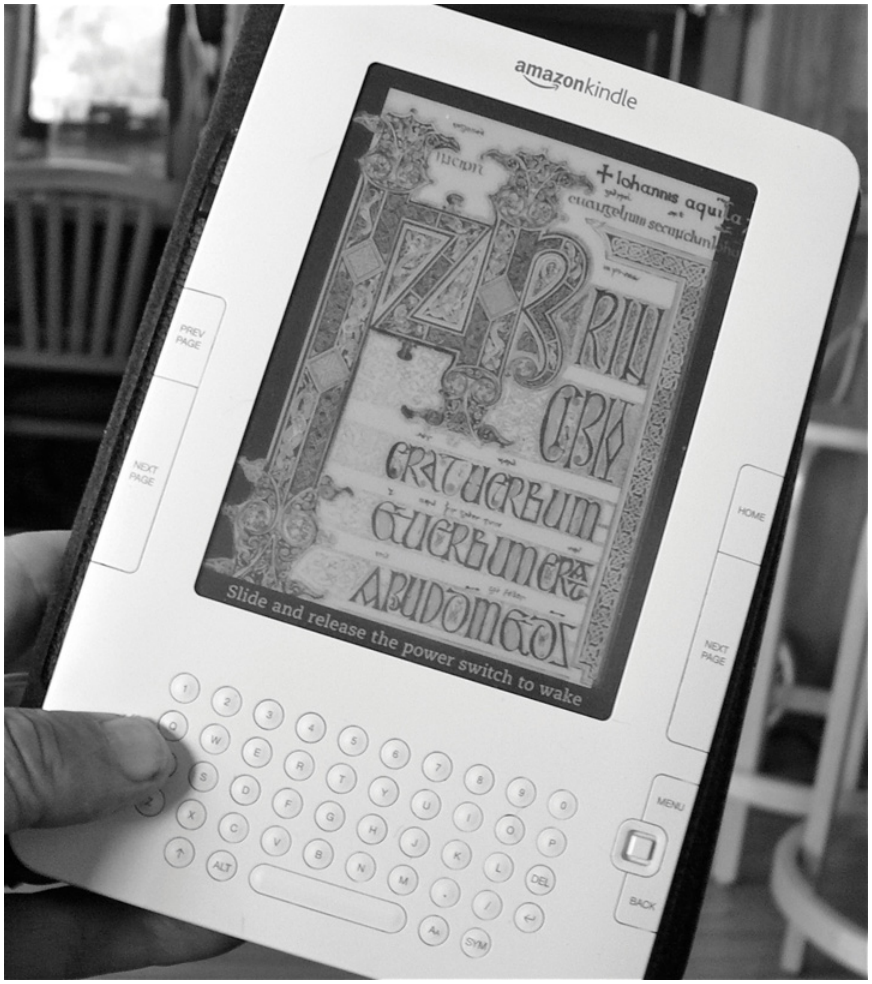


Figure 10.6.1: Amazon’s Kindle E-reader. Source: Photo courtesy of Larry Page, http://www.flickr.com/photos/igboo/3879913438.

Copyright infringement occurs when someone uses a copyrighted work without permission or violates the terms of a copyright license. For example, if a classmate takes your class notes without your permission and makes photocopies of them, the classmate has infringed on your copyright. It's also copyright infringement if you take someone else's work and simply repackage it as your own. This happened recently to Harry Potter author J. K. Rowling. Her books created a huge fan following, and many fans gather online to discuss the Potter series. One such site is the Harry Potter Lexicon, run by Steve Vander Ark, a former school librarian. The site serves as an encyclopedia to the Harry Potter world, with reference notes on characters, places, spells, and other details. When Vander Ark announced plans to publish the contents of the Lexicon in a book format, J. K. Rowling sued, claiming copyright infringement. The judge agreed and ordered the Lexicon rewritten so that it uses less material from the copyrighted work.

Copyright infringement also occurs when you assist someone in violating a copyright, or create a device that assists in violating a copyright. Thus, Web sites such as the former Napster and Grokster, which existed solely for the purpose of facilitating illegal downloading of music, were held to be infringers even though the Web sites themselves didn't violate any copyrights. Similarly, if you make digital media available for download for others, you are not engaged in illegal downloading but still liable for contributory copyright infringement. The recording industry, which is battling for its very survival in a new file-sharing world, pursues these cases aggressively. In June 2009, a court in Minnesota ordered Jammie Thomas to pay $80,000 per song for making twenty-four songs available for download, for a total fine of $1.92 million. In September 2009, the industry won a $675,000 verdict against a college student in Massachusetts for file sharing thirty songs. Devices that can be used for purposes other than violating copyrights (such as photocopiers, video/DVD burners, and peer-to-peer networks used for sharing research) are not considered infringing devices.

Copyright law makes a distinction between "fair" use and "infringing" use of a copyrighted work. A fair use includes copying a work for purposes of commentary, criticism, news reporting, teaching, or research. Just because a work is used in a news article or in a classroom, however, does not make its use fair. The law provides four factors that courts must consider in determining whether or not the use is fair. First, the court must consider the purpose and character of the use. Is it for educational purpose, or for making a profit? Second, the court must consider the nature of the copyrighted work. Is the work part of the "core" of the intended protection that copyright provides? Third, the court must consider the amount and substantiality of the portion used. This is an important factor—it's one thing for your professor to copy an excerpt from a journal or book for distribution in class (probably fair) and another to copy the entire journal or book (probably infringing). Finally, the court must consider the effect of the use on the potential market for the copyrighted work. If the use is considered fair, what would it do to the market for the copyrighted work? For example, if copying an entire textbook is fair, it would probably eliminate the market for new textbooks.

In an attempt to tackle the problem of copyright infringement on the Internet, Congress passed the Digital Millennium Copyright Act (DMCA) in 1998. One portion of the law helps Internet service providers by expressly stating that those providers can't be sued for copyright infringement if others use their networks for infringing uses. Another portion of the law helps Web sites by stating that if a Web site user uploads infringing material and the Web site complies with a copyright holder's request to remove the material, the Web site won't be liable for infringement. For example, if you upload a portion of a copyrighted song, movie, or television show to YouTube, you may find that YouTube has removed your clip at the request of the copyright holder. Finally, the DMCA makes it illegal to attempt to disable a copy protection device. DVD and Blu-ray Discs, for example, are copy-protected to prevent them from being copied easily. Anyone who writes software (even if the software is distributed for free) that disables this copy protection device is violating the DMCA. In recent years the DMCA has been used by companies to prevent competitors from making replacement inkjet cartridges, replacement garage door openers, and other replacement parts on the grounds that the replacements circumvent a copy protection device.

Key Takeaways

Copyright protects any creative work fixed in a tangible medium. Copyright protection is automatic without any prior government approval and generally lasts for seventy years past the death of the author. Copyright owners can license others to use their works while retaining full rights of ownership. Digital works are fully protected by copyright and may be encrypted with digital rights management schemes. Copyright infringement, both direct and contributory, is a serious civil violation that can result in heavy monetary penalties. Fair use is a defense to copyright infringement. The Digital Millennium Copyright Act prohibits any attempts to circumvent a copy protection device or scheme.

Exercise 10.6.1

1. How long do you think copyrights should last?
2. Do you think the use of copyrighted works in parody is fair use? Consider works by Weird Al Yankovic, or Mel Brooks movies, for example.
3. Do you think there is any difference between downloading a song on a peer-to-peer network versus walking into a store and putting a CD into your jacket and walking out without paying for it? What are those differences? Should the law treat those two acts differently?
4. Is downloading music justifiable because recording artists and companies make a lot of money? Can you think of other industries where this reasoning applies as well?

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10.7: Concluding Thoughts

The framers of the Constitution recognized the value of intellectual property (IP) by drafting the Copyright Clause into Article I, Section 8 as part of Congress's duty to pass laws. As IP law evolved, laws that govern trade secrets, patents, trademarks, and copyright have emerged to protect different forms of IP. These legal protections provide a solid foundation for businesses, entrepreneurs, and artists to create useful, innovative, and inspiring works for society. Our lives are enriched by machines to make tasks easier, medicines to heal us, and songs and movies to inspire and entertain us. Without the financial incentives provided by IP law, innovation would grind to a halt and the U.S. economy would become unrecognizable.

On the other hand, the Constitution is explicit about the primary purpose of providing IP monopolies: to advance the progress of science and useful arts. This advance can take place when IP owners create IP, but it can also take place when the IP falls into the public domain at the end of its "limited time." Many legal scholars now believe that Congress has gone too far in pleasing copyright holders, mainly large corporations with billions of dollars in profits at stake. In a case discussed in Chapter 7 "Torts" involving Samsung's use of a robot that looked like Vanna White, Judge Alex Kozinski from the Ninth Circuit Court of Appeals (Figure 9.7.1 "Judge Alex Kozinski") noted that sometimes the law does go too far in protecting IP:

Something very dangerous is going on here. Private property, including intellectual property, is essential to our way of life. It provides an incentive for investment and innovation; it stimulates the flourishing of our culture; it protects the moral entitlements of people to the fruits of their labors. But reducing too much to private property can be bad medicine. Private land, for instance, is far more useful if separated from other private land by public streets, roads, and highways. Public parks, utility rights-of-way and sewers reduce the amount of land in private hands, but vastly enhance the value of the property that remains.

So too it is with intellectual property. Overprotecting intellectual property is as harmful as underprotecting it. Creativity is impossible without a rich public domain. Nothing today, likely nothing since we tamed fire, is genuinely new: Culture, like science and technology, grows by accretion, each new creator building on the works of those who came before. Overprotection stifles the very creative forces it's supposed to nurture. *White v. Samsung Electronics*, 989 F.2d 1512 (9th Cir. 1993).



Figure 10.7.1: Judge Alex Kozinski. Source: Photo courtesy of the Ninth Circuit Court of Appeals, www.ce9.uscourts.gov/chief_judge_bio.html.

Judge Kozinski thinks that overprotecting intellectual property is as harmful as underprotecting it. Do you agree? The challenge for policymakers and courts is to find the balance between the rights of IP holders, who would always like more protection, and the

rights of the public, which are enhanced when material falls into the public domain. Corporations, policymakers, and members of the public will all benefit from a reasoned debate over how to find this balance.

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CHAPTER OVERVIEW

11: Workplace Privacy and Information Security

Learning Objectives

- Identify some of the most important privacy laws impacting businesses today.
- Understand the Constitutional basis for privacy rights.
- Explore the legal issues involved with modern technology and information security.

11.1: Introduction

11.2: Right to Privacy

11.3: Workplace Privacy

11.4: Information Security Issues

11.5: Concluding Thoughts

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11.1: Introduction

Privacy is a fundamental right of individuals that is often compromised by government and businesses. Sometimes individuals and businesses voluntarily give up their privacy rights, without considering the consequences of doing so. Workplace privacy and information security is a fast growing area of the law that has important implications across industries.

Counselor's Corner

Privacy and cybersecurity are two of the most dynamic areas of the law. As our society becomes more and more dependent on technology, and as the Internet of Things continues to expand, we are seeing privacy issues explode in personal and professional contexts. Businesses would do well to consult with cybersecurity and privacy experts to ensure that they are complying with the law and protecting their networks and confidential information as much as possible. Bringing in experts after you have a security breach or lawsuit filed is way too late. Be proactive. It just may save your business. ~Katie D., attorney

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11.2: Right to Privacy

Privacy is the right of a person or person's property to be free from unwarranted public scrutiny or exposure. In other words, it is the right to personal autonomy and to express oneself selectively. Privacy includes both bodily integrity and the protection of confidential information, including medical and financial records.

Implied Constitutional Right

Privacy is an **implied Constitutional right**, meaning it is a right based on the "zones of privacy" created by the US Constitution. However, the word "privacy" is not in the Constitution itself.

The right to privacy was first mentioned in a Harvard Law Review article in 1890 by Samuel Warren and Louis Brandeis, who later served on the US Supreme Court from 1916 until 1939. Warren and Brandeis argued the right to privacy is an important civil liberty which should not be violated by sensational journalists and developments in technology. The technology in the late 1890s they were the most concerned with was photography and telephones. In particular, they were concerned about people losing their right to privacy when others take photographs of them or listen to their conversations.

Privacy was discussed in the legal community for 75 years before the US Supreme Court expressly held individuals have a Constitutional right to privacy in the 1965 *Griswold v. Connecticut* decision.

Privacy cases involve different circumstances, such as the right to choose whether to marry and to whom, the right to choose whether to have children, and the right to protect confidential information such as medical and financial records.

The Framers of the Constitution did not include the word "privacy" in the Constitution but it is a fundamental right underlying the core tenets of the document. The Bill of Rights begins by recognizing fundamental rights that are essential to an individual's identity: speech, religion, press, assembly, and petition for redress from the government. From there, the Bill of Rights expands protection of individuals to include their homes and possessions. For example, the Fourth Amendment prohibits unreasonable searches and seizures by the government. As reflected in the Bill of Rights, privacy is an essential right the Constitution intends to protect.

When analyzing privacy cases, courts ask whether an individual has a reasonable expectation of privacy. To establish a "reasonable expectation of privacy," a person must meet two requirements:

1. **The individual has an actual, subjective expectation of privacy**. In other words, did that particular person think he or she was doing something in private that others could not observe?
2. **Society accepts the individual's expectation of privacy as reasonable**. In other words, as a community do we expect those circumstances to be private?

This legal test has both a subjective and objective standard. If an individual does not expect their actions to be private, then no right to privacy exists under the circumstances. Similarly, if society as a whole does not expect to have privacy under the circumstances, it does not matter what the individual may personally believe, no right of privacy exists.

For example, if a person calls her doctor to discuss medical test results, then she has a subjective expectation of privacy. If she calls her doctor from her home, then she has an objective expectation of privacy because society recognizes the right of people to have private conversations in their own homes. However, if she has the conversation on her cell phone while riding the bus, then she does not have a right to privacy because it is not objectively reasonable to expect privacy on public transportation.

Privacy cases also focus on whether a person has given either express or implied consent to disclose or use personal information. **Express consent** is often given in the form of contracts, including end user agreements. Implied consent is usually based on the person's actions, such as a history of business transactions. In essence, **implied consent** means that a business has reason to believe that a person would give consent if the business asked for it. For example, customers who sign up for a loyalty program may give implied consent to receive marketing emails from that particular business.

While consent and the expectation of privacy are interrelated concepts, they are legally different concepts.

Statutes

Congress and state legislatures have also passed various laws to protect the privacy of individuals and their property. Some of the most important federal laws related to workplace privacy are discussed below.

There is a growing trend among states to require internet service providers to obtain consent from consumers before sharing any of their personal information, including websites visited and consumer habits.

Businesses engaged in e-commerce with residents of California must post their privacy policy conspicuously on their websites and abide by their policies. California law also requires disclosure of consumer software tracking policies.

International Law

The right to privacy is contained in Article 12 of the Universal Declaration of Human Rights, which was adopted in 1948 in response to the horrors of World War II. The Universal Declaration of Human Rights states:

No one shall be subjected to arbitrary interference with his privacy, family, home or correspondence, nor to attacks upon his honor and reputation.

The Universal Declaration of Human Rights has been adopted by the majority of nations, including the United States.

Many other bilateral treaties and conventions recognize the right to privacy in various circumstances. Currently, about 150 nations recognize privacy as part of their international legal obligations. However, enforcement of the right to privacy is inconsistent across nations.

It is important for US businesses operating in Europe or conducting business transactions with Europeans to understand that the European Union (EU) has a comprehensive set of laws to protect the privacy of European individuals and businesses. The **EU General Data Protection Regulation (GDPR)** applies to all businesses, even located outside of Europe, that collect, store, or process data about any European. Under GDPR, individuals have the right to know how their personal data is being collected and used, to remove information from the internet, and to stop companies from processing their data. GDPR has significant penalties. For example, businesses mishandling customer information may be fined up to four percent of their annual worldwide revenue.

Under GDPR, businesses must comply with six data processing principles. Personal information must be:

1. Processed lawfully, fairly and transparently;
2. Collected only for specific legitimate purposes;
3. Adequate, relevant and limited to what is necessary;
4. Accurate and, where necessary, kept up to date;
5. Stored only as long as is necessary; and
6. Processed in a manner that ensures appropriate security.

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11.3: Workplace Privacy

Employees generally do not have a reasonable expectation of privacy in the workplace, especially when using company equipment or when the employer has a policy stating employees may be monitored. However, some areas such as employee restrooms and locker rooms may not be monitored. Courts have held employees do not give up all expectations of privacy by the nature of their employment. Therefore, employers should ensure that they limit monitoring activities to reasonable places where the employer has a legitimate business interest for doing so.

Hiring Process

Employers often run background checks on prospective employees as part of their hiring process. Depending on what type of background check is done and the information used, a range of privacy issues are involved. Some states regulate the type of documents that a prospective employer may consider when making hiring decisions. Businesses need to ensure they comply with all state laws where they hire employees.

The use of artificial intelligence (AI) is a growing trend in recruiting and hiring. AI is often used to review resumes, applications, and publicly available social media. AI-powered video-interview platforms apply algorithms to video-recorded interviews to facilitate an employer's assessment of applicants.

Illinois was the first state to pass an AI Interview Act, which requires prospective employers to notify applicants of their use of AI and to obtain their consent before using AI tools on their application materials. Although limited to its state, the Illinois law has been cited by many legal experts as a template for other federal and state laws.

Based on the Illinois law, employers who use AI during their hiring process should adopt the following best practices:

- Give notice to applicants of the use of AI-powered video-interview platforms;
- Explain what the AI is and how it works in ordinary language to applicants;
- Obtain consent of applicants to use and record their video interviews;
- Offer an alternative interview method for interviews; and
- Have a procedure in place for the destruction of recordings.

Drug and Alcohol Testing

Employers with drug and alcohol testing policies are highly regulated by the states where they operate. State requirements vary about required notice of testing, the nature and location of testing, and when testing may occur. All states protect employee privacy regarding who receives the test result and how those results are to be collected, stored, and destroyed. Employers who engage in drug and alcohol testing need to be informed about the legal consequences of enforcing their policies.

Employees frequently challenge drug and alcohol testing as a violation of their right to privacy. Employers generally win these lawsuits when:

- The employer complies with all state requirements for drug and alcohol testing;
- Conducts the test with the employee's consent;
- Conducts the test in a manner that was not offensive; and
- The test results do not reveal information unrelated to the purpose of the test.

Employers must be careful to limit disclosure of test results to only those with a need to know. Businesses may lawfully conduct a drug or alcohol test but still be liable for privacy violations based on how they handled the results.

Health Insurance Portability and Accountability Act

The Health Insurance Portability and Accountability Act of 1996 (HIPAA) seeks to protect confidential health information and mandates standards for handling such information.

HIPAA has a Privacy Rule regulating the use and disclosure of individually identifiable health information. The Privacy Rule protects **Protected Health Information (PHI)** , which includes all information related to the past, present or future health status of an identified individual, of treatment received, or of payment for treatment. PHI also includes billing records, information about premium payments, and enrollment information. As a result, PHI includes medical information required by employers to carry out

their obligations under the Americans with Disabilities Act, the Family Medical Leave Act, workers' compensation, drug testing, and employer-sponsored health care plans.

HIPAA also has a Security Rule to ensure the confidentiality, integrity and availability of electronic PHI. Under the Security Rule,

- **Confidentiality** means PHI is not made available or disclosed to unauthorized individuals or processes;
- **Integrity** means PHI is not altered or destroyed in an unauthorized manner; and
- **Availability** means PHI is accessible and usable upon demand by an authorized individual.

The Security Rule also requires businesses to protect electronic PHI against reasonably anticipated threats and reasonably anticipated violations of the Privacy Rule.



Figure 21.1 HIPAA Security Rule

HIPAA requires businesses to designate a single person who is ultimately responsible for the security of electronic PHI. This person is also responsible for ensuring the business engages in the mandatory security management process under HIPAA. This process starts with a risk analysis of the potential vulnerabilities in the business's system and management of PHI. The security management process is extensively regulated.

Importantly, HIPAA applies to "covered entities" rather than specific types of information. Personal fitness trackers such as Fitbit, gather what is essentially healthcare data of its consumers. However, Fitbit data can be sold as consumer information because Fitbit is not a covered entity under HIPAA with regard to its consumers. However, if Fitbit gathers PHI of its employees who request medical leaves of absence, then Fitbit is a covered entity as an employer.

Electronic Monitoring

Federal law and most state laws allow employers to monitor their employees' electronic communications occurring over the employer's hardware, software, and servers. If the employer provides the computer system, the employer has the right to monitor electronic communications on the system, even if those communications are not work related.

Employers may also monitor communications when employees consent to the monitoring. Therefore, many employers require employees to sign a waiver consenting to private communications sent via the employer's equipment to be monitored. This helps defend against invasion of privacy claims better than having a policy in the employee handbook alone.

Businesses may also monitor conversations with customers in the ordinary course of business as long as they give notice. As a result, many customer service lines use a recorded message that "this call may be monitored for training purposes" before customers are connected to a customer service agent.

The most important federal law regarding monitoring of electronic communications is the **Electronic Communications Privacy Act (ECPA)**, which was passed by Congress in 1986. ECPA has two parts. The first part is known as the Wiretap Act and the second as the Stored Communications Act. ECPA prohibits the acquisition of the the content of a wire, oral or electronic communication using an electronic, mechanical or other device. ECPA also prohibits the use or disclosure of an unlawfully intercepted communication.

ECPA exposes businesses to multiple levels of liability within a business. For example, personnel in the IT department may be liable for unlawfully intercepting an employee's email, and human resource personnel who use and disclose the email may be liable as well. Each unlawfully intercepted communication may give rise to liability. Therefore, a handful of communications may result in multiple individuals throughout a business repeatedly violating ECPA.

Workplace Recordings

Although recordings may be useful to capture the content of a conversation, recordings pose legal and business risks to employers. Both employers and employees may violate federal and state wiretapping laws by recording conversations without consent of the other parties. Even with consent, businesses that engage in recording employees and customers damage employee morale and risk losing customers.

Twelve states prohibit recording a conversation unless all parties consent. The majority of states allow customers and employees to hold a business liable for wiretapping violations under the respondeat superior doctrine. As a result, businesses may be liable for their employees' unlawful recordings if done in the course and scope of employment or done to help the business.

State and federal wiretapping laws carry both civil and criminal penalties. Many state laws provide for treble damages or a statutory damage amount. Federal wiretapping laws impose fines up to one hundred dollars per day or ten thousand dollars, whichever is greater.

Another potential problem for businesses is putting confidential business information at risk. For example, employees may capture trade secrets, proprietary information, or business strategies that the business wants to protect. Recorded information can be compromised or shared against the business's interests.

Social Media

An employer's right to monitor electronic communications generally does not include social media. As a result, employers are not entitled to monitor social media accounts through coercion or deceit. For example, an employer cannot require employees to provide passwords to their social media accounts. Employers also cannot log onto the social media accounts of others (including employees) and pose as them to see private accounts.

However, if social media accounts are public, then employers are entitled to review them to the same extent as other members of the public.

Videotaping and Surveillance Cameras

ECPA only protects electronic communications. As a result, ECPA does not apply to video or camera surveillance without an audio component. To avoid violating ECPA, businesses should ensure their security and surveillance cameras do not capture human

voices.

Security cameras cannot be used in areas in which employees and customers have a reasonable expectation of privacy. For example, retailers cannot use cameras in changing rooms, restrooms, and locker rooms. Businesses need to place cameras so that private activity cannot, and is not, monitored and recorded.

Businesses engaged in surveillance must use the most limited means available to conduct the surveillance. Companies should have a legitimate business reason to use security cameras, and they need to ensure the surveillance is targeted and limited in duration and scope.

Retailers who use cameras to prevent theft at entryways and cash registers should place cameras in positions that are open and obvious to act as notice to customers. Signs giving express notice are also a best practice to avoid legal liability.

Biometrics and Wearable Technology

Biometrics is the automated identification of people using their physical characteristics. While many metrics can be used, fingerprints and facial recognition are the most common. It is helpful to think of biometrics as measurements of some aspect of a person.

There is a growing trend among businesses to move from traditional time clocks to biometric time clocks that scan fingerprints, retinas, or irises to verify an employee's identity and clock the employee in and out of work. Biometric time clocks prevent time clock fraud, increase timekeeping efficiency, and increase accuracy of wages.

The type of biometric technology used impacts the privacy rights involved. Technology storing biometric data directly impacts privacy rights more than technology creating a "template" through an algorithm to create a representation of a fingerprint. Whether the technology captures and uses existing personal information or creates a replica has legal consequences.

There have been a series of class action lawsuits against employers that have not notified employees when their biometric identifiers and data were being shared with third party timekeeping vendors. Consent is only a defense for employers if they give notice and obtain consent for all uses of the information.

Another technology trend is the use of wearable technology. **Wearable technology** is a category of electronic devices that can be worn as accessories, embedded in clothing, implanted in the user's body, or even tattooed on skin. The devices are intended to be hands-free, are powered by microprocessors and connect with the Internet. Wearable technology includes smartwatches, fitness trackers, and medical devices. It is helpful to think of wearable technology as something that an employee has.

Wearable technology is often used to track employee locations and grant access to areas. Concerned about private companies coercing employees to be microchipped, states are passing laws prohibiting employers to require, coerce, or compel an individual to receive a microchip implant or use wearable technology as a condition of employment.

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11.4: Information Security Issues

Information security is one of the fastest growing areas of the law affecting businesses today. Any business that collects, uses, and stores personal information about employees and customers is subject to these laws. Businesses are also increasingly targeted by hackers who seek to steal private information on a large scale.

Security Analysis

A simple but widely-used security model is the **CIA Principle** or **CIA Security Rule**, which stands for Confidentiality, Integrity and Availability. The principle is applicable across points of contact from access to a user's internet history to security of encrypted data across the Internet.

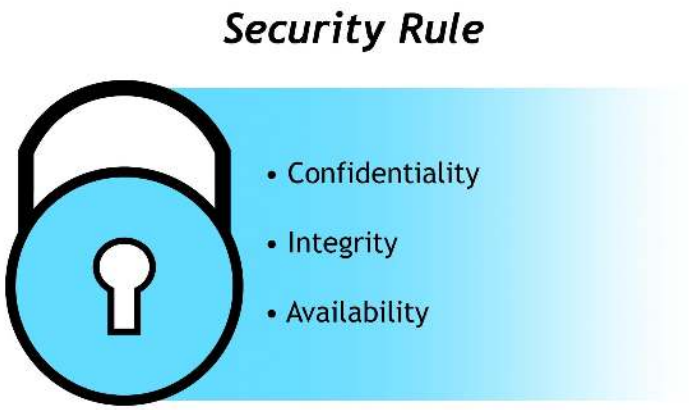


Figure 21.2 CIA Principle

Confidentiality is the ability to hide information from those without authorization to view it. While perhaps the most obvious principle, it is usually the one that is attacked most often. Cryptography and Encryption are methods used to protect confidentiality of data transferred across the Internet.

Integrity is the ability to ensure that data is an accurate and unchanged representation of the original information. One common security attack is to intercept some important data and make changes to it before sending it on to the intended receiver.

Availability is the ability to make information readily accessible to authorized users at all times. Some security attacks attempt to deny access to appropriate users, either to inconvenience them or to achieve another goal such as redirecting business to a competitor.

As discussed in Section 21.3 above, HIPAA's Security Rule requires covered entities to implement the CIA principle to protect PHI.

Data Breaches

According to the Pew Research Center, almost eighty-five percent of individuals in the US shop online. And most retailers collect customer's personal and financial data. If a customer uses a form of payment other than cash, then the customer's personal and financial information will be shared with the business.

Rather than pickpocket an individual consumer, thieves today are targeting businesses to collect personal and financial information of entire consumer sets. Data breaches affect all industries, such as retail, credit bureaus, hospitals, and government agencies. In the first half of 2019, there were over 4.1 billion compromised documents reported as part of only 3,800 disclosed data breaches.

Cybersecurity experts advise that cyber criminals run automated online scripts looking for unsecured databases. While some larger businesses are particularly targeted, cyber criminals are the most successful when targeting small to medium-sized businesses that are unaware of the threat or do not want to spend adequate resources on cybersecurity.

Businesses should be aware, though, that approximately sixty percent of data breaches are the result of human error rather than outdated or insufficient technology. Therefore, by adequately training employees, many data breaches may be avoided. For example, breaches often result from sending emails to the wrong person, responding to phishing attacks, sharing passwords, and leaving computer screens open.

Another big risk is when people use the same password for multiple accounts, such as email accounts, bank accounts, and social media. If the password is obtained by cyber criminals and added to the database of passwords, all the accounts will be at risk.

Big Data

In addition to financial data, businesses collect personal information about consumers and their habits. This is called **big data**. Consumer information is very valuable because businesses can search the data to identify spending habits to target marketing to likely customers. This reduces costs and increases profit for businesses, especially as e-commerce increases the number of competitors across industries.

Another benefit to mining the data available about consumers is businesses can make more profitable decisions. For example, health insurance companies are heavily invested in big data because they want information about the lifestyle habits of the people they insure and potentially insure. If they know someone is a smoker, eats a lot of sugary foods, or has a sedentary lifestyle, then they can adjust premiums accordingly to minimize their risk. Insurance companies look for trends not just for individuals but also regions, types of occupations (including those with the highest risk of addiction or obesity), and socio-economic status.

Big data is also connected to the Internet of Things. The **Internet of Things (IoT)** is a system of interrelated computing devices, mechanical and digital machines, objects, animals or people that are provided with unique identifiers and the ability to transfer data over a network without requiring human-to-human or human-to-computer interaction. In other words, the IoT includes everyday devices connected to the internet, including medical devices, appliances, vehicles, and buildings.

As more businesses seek big data about consumers and sell IoT items to consumers, privacy rights are impacted. Data collection in public spaces, such as billboards tracking who stops to read them, may be lawful. However, the location and manner of data collection involves different expectations of privacy. For example, businesses argue that by purchasing and installing “smart home” appliances and products, consumers have consented to surveillance and data collection. Consumer advocacy groups argue that purchasing goods for a particular use does not give consent to businesses to invade consumer privacy in their homes. These issues will be heavily litigated in the years to come.

Transborder Data Transfers

As discussed previously, the EU has a comprehensive set of privacy laws and regulations. The EU has strict limits on the export of all human resources data and consumer information to the US, even when the data export occurs within the same business. To help US businesses comply with the EU laws, the US Department of Commerce negotiated a “safe harbor” of data protection practices that the EU approved. If a US business can certify its compliance with the Safe Harbor Principles, then the EU will approve data transfers to that business.

Security Incident Preparation and Response

Businesses are not able to prevent all data security breaches. However, businesses need to take steps to protect against known and reasonably anticipated threats to confidential information. For businesses without sufficient in-house cybersecurity staff or expertise, **Managed Security Service Providers (MSSPs)** offer a wide range of security services, including setting up security infrastructure and incident response.

Although federal and state laws vary regarding legal requirements, a business should have a written cybersecurity program that conforms to their industry’s recognized cybersecurity framework.

In general, a cybersecurity program should:

- Protect the security and confidentiality of all electronically stored records containing an employee or customer’s social security number, driver’s license number, state identification card number, credit and debit card information, dates of birth, passwords, and personal information;
- Protect against any anticipated threats or hazards to the security or integrity of the confidential information;

- Provide for reliable and accurate backups of data; and
- Protect against unauthorized access to and acquisition of information likely to result in an employee or customer being exposed to a material risk of identity theft or fraud.

Many laws, including HIPAA, have cybersecurity regulations with which businesses must comply. Certain industries have also issued their own security standards. For example, the Payment Card Industry (PCI) Security Standards Council has issued standards for the safety of credit and debit cardholder data across the globe.

Businesses wanting information about implementing cybersecurity programs that are appropriate for their industry should consider the National Institute of Standards and Technology's (NIST) Framework for Improving Critical Infrastructure Cybersecurity. The mission of NIST is to help organizations understand and improve their management of cybersecurity risks. It is an excellent place to start when analyzing cybersecurity issues.

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11.5: Concluding Thoughts

The internet and technology are changing the world at an incredibly fast pace. With those changes come the challenges to individuals and businesses to maintain privacy and protect personal information. Privacy is an implied Constitutional right deeply impacted by the use of technology. Regardless of type of industry, businesses need to have adequate cybersecurity policies and practices in place to protect confidential business, employee, and customers information.

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12: Contracts

10.1 Introduction

LEARNING OBJECTIVES

1. Explain what constitutes a contract.
2. Understand how a contract is formed.
3. Know the defenses to performance of a contract.
4. Understand breach of contract and its consequences.
5. Identify remedies for breach of contract.

Although businesses tend to use the terms “agreement” and “contract” interchangeably, legally the terms have very different meanings. An **agreement** is a mutual understanding between two or more parties about their rights and duties toward each other. A **contract** is a legally enforceable agreement between two or more parties. All contracts are agreements, but not all agreements are contracts.

When contracts are broken, or breached, the injured party can seek damages. In contracts, this usually means an amount that would make that party whole again.

Generally speaking, contracts are a form of **private law**, because the terms of the contract are binding on the parties to the contract but not anyone else. 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.

Contracts may restrict parties’ future activity. For example, a non-compete clause in an employment contract may be enforceable in the future against an employee after termination of employment.

However, contracts that are illegal or against public policy are not enforceable.

Contract law performs three significant economic functions:

1. It helps individuals and businesses exchange goods and services efficiently.
2. It reduces the costs of economic transactions because parties do not need to negotiate a variety of rules and terms with each separate transaction.
3. It alerts the parties to problems that have arisen in the past, making it easier to avoid potential pitfalls.

Counselor’s Corner We live in a world of contracts, which are the bread and butter of business transactions. However, many consumers, employees, and small businesses are afraid to read and understand contracts. That fear allows others to take advantage of them. Take the time to read contracts provided to you. Ask questions about anything you don’t understand *before* you sign. Have the courage to revise and edit contracts to ensure your interests are protected. Or even write your own. It’s not hard and the more you do it, the more confidence you will have to negotiate business transactions and protect your interests. ~Darnell T., attorney

10.2 Contract Elements

There are three required elements of a contract: offer, acceptance, and consideration. It is important to note that some states and legal scholars expand this list to include whether the subject matter is legal, whether the parties have capacity to enter into a contract, and whether the law requires the contract to be in writing to be enforceable. However, these are best understood as defenses to contract formation, especially in light of the fact that the only elements that all states agree on are offer, acceptance, and consideration.

Offer

All contracts start when an individual or business proposes a deal. It might involve buying or selling goods, performing services, or making an exchange. An **offer** is a conditional promise to do or refrain from doing something now or in the future. In other words, it is willingness to enter into a contract.

Offers can be formal or informal. In some industries, such as retail and restaurants, offers are often posted on menus, signs, and advertisements. For example, a sign hanging above a cash register listing menu items and their prices is the restaurant’s offer to sell

customers those items at those prices.

There are not a lot of legal requirements about what an offer must contain, but there are some things that cannot be a legal offer:

Type of Invalid Offers	Definition	Example
Illusory Promise	No offer exists because there is no duty to perform	"If I decide to buy a new car, I'll give you my old one."
Pre-existing Duty	A party cannot leverage an existing duty to get more out of someone else	"I agree to teach you business law for $100 even though you have already paid tuition for the course."
Forbearance	An offer cannot be a promise not to pursue a legal claim that is known to be invalid (Note: if the claim is valid, then forbearance may be a valid offer)	"I know the accident was completely my fault but I promise not to sue you."
Past Consideration	An offer cannot be based on past actions	I paint your house. Two months later you say that you will pay me $500 for doing it. If you change your mind and decide not to pay me, I cannot enforce your promise because it was in consideration of a past event.

Once made, offers can be terminated in a number of ways. An offer that has been properly communicated continues to exist until it:

1. Is rejected;
2. Is replaced by a counteroffer;
3. Lapses or expires;
4. Is revoked; or
5. Is terminated by operation of law.

Unless it states a specific time, an offer remains open for a reasonable time. A **lapsed offer** is an offer that is no longer valid because a reasonable time to accept it has expired. An expired coupon is an example of a lapsed offer.

Acceptance

To constitute an agreement, there must be an acceptance of the offer. Legally, **acceptance** is an implied or express act that shows willingness to be bound by the terms of an offer. To be effective, both parties must understand and agree to be bound by the contract.

Acceptance can be both express or implied. Express acceptance occurs when a party states that they accept the offer. Acceptance may be implied based on the parties' conduct. For example, a retailer offers to sell a product to consumers for the price listed on the shelf. A consumer may accept that offer by handing the cashier the item and money to pay for it. The consumer does not need to say anything to complete the transaction. But the consumer must do *something* to accept. Silence, without more (such as handing over payment), is not acceptance. This is because silence may be evidence that the consumer either does not know about the offer or has rejected it.

A common problem in the business community is knowing what constitutes acceptance and what is negotiation. If an acceptance changes, adds, or modifies terms of the offer, it is a **counter-offer** and no contract is formed. The original party may decide to accept, reject, or propose another offer as a result. Although this sounds straightforward, with today's fast-paced communications, parties may respond to part of an offer, negotiate various parts of the contract simultaneously, or agree to terms in installments. As a result, there may be confusion about what the full terms of a contract are.

Offer and acceptance form **mutual assent**, which is also called "meeting of the minds." This is the parties' intention to enter into a binding contract on the terms they agreed upon. If parties do not agree on the essential terms, then there can be no meeting of the minds to enter into a contract. This is the basis for many of the defenses to contract formation.

Consideration

Consideration is the bargained-for exchange of something of value that shows the parties intend to be bound by the contract. There are two elements to consideration:

1. Something of value
2. Is exchanged between the parties.

The "something" that is promised or delivered must be a legal detriment. A **legal detriment** is giving up a legal or property right.

Consideration may be concurrent or a promise to perform in the future. However, it cannot be "past consideration" based on something that has occurred before the formation of the current contract. In other words, an act or promise made before the current contract is not adequate consideration because it was not given in exchange for the current promise.

When bargained-for consideration is not present, a court may validate a promise based on promissory estoppel. **Promissory estoppel** is the principle that a promise made without consideration may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise, and the promisee actually relied on the promise to his or her detriment. Promissory estoppel is an equitable doctrine used as a substitute for consideration that allows the imposition of contractual liability to prevent unfairness.

To establish promissory estoppel, a party must show:

1. A definite promise;
2. The party making the promise should have expected that the other party would rely on the promise;
3. A reasonable person would have relied on the promise;
4. The party relied on the promise and it resulted in a substantial detriment; and
5. Basic justice and fairness require that the promise be enforced.

10.3 Types of Contracts

Bilateral and Unilateral Contracts

In a **bilateral contract**, both parties make a promise of performance. These contracts are also called mutual or reciprocal contracts. Bilateral contracts are the most common form of contracts. They include ordering food in a restaurant, buying gas for vehicles, purchasing goods and services, etc.

A **unilateral contract**, on the other hand, is a contract where one party makes a promise that the other party can accept only by doing something. For example, a business offers a reward for information leading to the arrest of a thief. A person cannot collect the reward money by promising to give information–he or she must perform under the contract by providing the information.

Express and Implied Contracts

An **express contract** is a contract in words (orally or in writing) in which the terms are spelled out directly. The parties to an express contract, whether written or oral, clearly intend to make a legally enforceable agreement. For example, an agreement to buy a car for $1,000 and to take title next Monday is an express contract.

An **implied contract** is a contract that is inferred from the parties' actions. Although no discussion of terms took place, an implied contract exists if it is clear from the conduct of the parties that they have an agreement. 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.

Quasi-contract: Contract Implied in Law

Both express and implied contracts embody an actual agreement of the parties. A **quasi-contract**, by contrast, is an obligation imposed by law to avoid unjust enrichment of one person at the expense of another. In fact, a quasi-contract is not a contract at all. It is a judicial remedy in which the court decides what a contract should look like between the parties to prevent injustice. For example, a carpenter mistakenly believes a homeowner hired him to repair her porch, when it was actually the neighbor who hired him. One morning the carpenter arrives and begins work. Rather than stop him, the homeowner lets him proceed, excited to get her

porch fixed for free. Although no contract exists because there was no offer, acceptance or consideration, the law will imply a contract between the carpenter and homeowner for the value of the work.

Enforceability

A contract that is fully enforceable and reflects the parties' intent is **valid**. Conversely, an **unenforceable contract** is a contract where the parties intend to form a valid bargain but the court declares that it cannot be enforced for legal reasons. For example, Ramesh owes Jai money, but Jai has waited too long to collect it and the statute of limitations has run out. The contract for repayment is unenforceable and Jai is out of luck unless Ramesh makes a new promise to pay or actually pays part of the debt.

An agreement that is lacking one of the legal elements of a contract is **void** because it never was a contract. In other words, it is not legally enforceable because it is not a contract at all. An agreement that is illegal is also void. For example, a promise to commit a crime in return for payment is void because neither side can enforce the agreement in court.

By contrast, a **voidable contract** is a contract that can be annulled. It is a contract that is unenforceable by one party but enforceable by the other. For example, a minor may "avoid" a contract with an adult; meaning the adult may not enforce the contract against the minor if the minor refuses to carry out the bargain. The adult must comply if the minor wishes the contract to be performed. A contract may be voidable by both parties if they are both minors. Usually, the parties to a voidable contract are entitled to be restored to their original position.

A voidable contract remains a valid contract until it is voided. Thus, a contract with a minor remains in force unless the minor decides he does not wish to be bound by it. When minors become adults, they have two choices:

1. **Ratify** the contract–that is, agree to be bound by it; or
2. **Disaffirm** the contract–that is, disavow or avoid it.

Ratification may be explicit or implicit. For example, by continuing to make payments or retaining goods for an unreasonable period of time, a party may ratify the contract. If a party has not disaffirmed the contract while still a minor, she may do so within a reasonable time after becoming an adult.

Degree of Completion

An **executory contract** is a contract that has yet to be completed. Most executory contracts are enforceable. If some, but not all, of the terms of the contract have been performed, the contract is called **partially executed**. A contract that has been completed or carried out fully by both parties is called an **executed contract**.

10.4 Performance and Breach of Contract

Performance simply means undertaking the legal duties imposed by the terms of the contract.

But how do we know whether the contract terms have been performed? Sometimes it's easy to determine. For instance, if someone offers to sell his scooter for four hundred dollars, a purchaser agrees, and they exchange the scooter for the money, then the contract has been fully performed. A contract was formed, the parties performed their obligations under it (known as **complete performance**), and they are subsequently discharged from further duties arising under the contract. Complete performance results in an executed contract.

When a party fails to perform under the terms of the contract without a legally justifiable reason, the party is in **breach of contract**. Not all breach of contract situations give rise to litigation. Some breaches are minor and may be overlooked by parties, especially if there is a long-term business relationship between them. Others may be major and give rise to significant issues between the parties.

In a service contract, the standard used to judge performance is **substantial performance**. This means that the performing party acted in good faith and conveyed enough benefit to the other party under the contract that any breach may be remedied by money damages. A **material breach** in a service contract occurs when a party has not substantially performed under the terms of the contract. A **minor breach** occurs when the party has substantially performed but has not strictly performed.

Performance to the standard of **personal satisfaction** can be enforced if the contract expressly requires it. This means that contract performance is evaluated 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. These contracts often occur in the entertainment industry, as well as the building of custom homes.

Conditions

A **condition** is an act or event (other than the lapse of time) that must occur before performance under a contract becomes due. Conditions determine when a party must perform.

Type of Condition	Description
Condition precedent	A condition must occur before a party's performance is required
Concurrent condition	Each party's performance is dependent on the other party's performance
Subsequent condition	A condition follows the duty to perform that completely eliminates or discharges a duty to perform
Constructive condition	Equitable doctrine that serves as an implied-in-law condition to prevent injustice

A **condition precedent** is an act or event that must occur before a duty of immediate performance of a promise arises. For example, an inspection of property is a condition precedent to the sale of a home.

A **concurrent condition** occurs when mutually dependent conditions must be performed at the same time by the parties. For example, delivery of goods and payment in a cash sale are concurrent conditions.

A **subsequent condition** is an event that discharges a duty of performance that becomes absolute. They are rare and tend to occur in the insurance industry. For example, an insurance company may require notice within thirty days of a claim. The insurance company does not have a duty to pay until the insured gives notice. Notice is the subsequent condition that triggers the insurance company's performance.

A **constructive condition** is a condition contained in an essential contractual term that, though omitted by the parties from their agreement, a court has supplied as being reasonable in the circumstances. It is an equitable doctrine that serves to imply conditions to prevent injustice.

10.5 Defenses to Contracts

A party may have a valid reason for **breaching**, or not performing, a contract. These reasons are known as defenses to contract. Many of the defenses to contracts go to the heart of whether an agreement ever existed. In other words, if a party does not voluntarily consent or there was no "meeting of the minds," then a valid contract was never formed.

Illegality

Illegal contracts are unenforceable because they are void. There are two common types of illegalities: (1) statutory violations, and (2) violations of public policy. An example of a statutory violation is where a company in the US wants to avoid import regulations and quotas by purchasing Cuban cigars through an intermediary in Mexico. If the US buyer pays the Mexican intermediary for the cigars but does not receive them, the buyer cannot sue the intermediary for breach of contract. The law will not provide a remedy to someone who intends to violate the law.

Examples of violations of public policy often occur in an employment context. An employer that tries to bind its employees to unreasonable non-compete agreements violates the public policy of freedom to work. Another common example is contracts with professionals who do not maintain a current license in their field. If they are not legally licensed for the work they perform, they are not entitled to payment for their services. Here, the public policy is that the law does not want to encourage a black market for services outside of government regulation.

Incapacity

If someone lacks mental capacity to understand the terms of the agreement, there cannot be a true meeting of the minds to form a contract. **Capacity** is the mental state of mind sufficient to understand that a contract is made and its legal consequences.

Incapacity can be permanent, such as from mental illness, physical illness, or insanity. Incapacity may also be temporary, such as being intoxicated, under the influence of drugs, or underage (i.e. under eighteen years old).

Undue Influence

Undue influence occurs when one party overpowers the free will of another by use of superior power or influence. In other words, it is unfair persuasion. Undue influence is not a normal level of persuasion. Rather, it occurs when a party agrees to a contract that they would not have otherwise consented to without the unreasonable pressure of the other party. For example, an elderly person who is isolated from others due to poor health and living conditions may be lonely and eager for company. If a caretaker exerted influence over the elder to the extent that he or she could no longer exercise free will, then undue influence occurs. Contracts and transactions in which elders transfer most or all of their wealth to others are frequently reviewed for undue influence.

Duress

Duress occurs when there is a threat to a person, family or property. Economic pressure may constitute duress if it is wrongful and oppressive. Cases involving duress often occur in emergency situations. For example, when someone is required to sign legal paperwork in an emergency room before receiving medical treatment for themselves or their children.

If a person enters into a contract under duress, he or she is able to get out of the contract after the emergency situation is over. Duress essentially overcomes a person's free will to voluntarily choose to enter into the contract.

Unconscionability

Unconscionability occurs 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. Common cases involving unconscionability claims occur when one party is an experienced business dealer, while the other party is an average consumer. If the business dealer uses a very small font and inserts terms into the contract in a way that intentionally misleads the consumer into signing on unfair terms, then the contract may be deemed unconscionable.

Statute of Frauds

The **Statute of Frauds** requires certain contracts to be in writing and signed to be enforceable. The Statute of Frauds originated in England in 1677 to prevent fraud when one party tries to claim a contract existed when it did not. The Statute of Frauds requires a written contract for:

1. Real property interests;
2. Marriage;
3. Payment of another's debt;
4. Contracts that cannot be completely performed within one year;
5. Contracts for the sale of goods of five hundred dollars or more; and
6. Acting as another's executor/administrator.

Statute of Limitations

The **statute of limitations** is an affirmative defense that can be raised by a defendant to argue that a lawsuit is being brought too late. This means that if a dispute arises under a contract, then the plaintiff must bring a lawsuit concerning that dispute within a certain time period. States have different statutes of limitations. If a contract has a choice of law provision, then that state's statute of limitations will apply to disputes related to the contract.

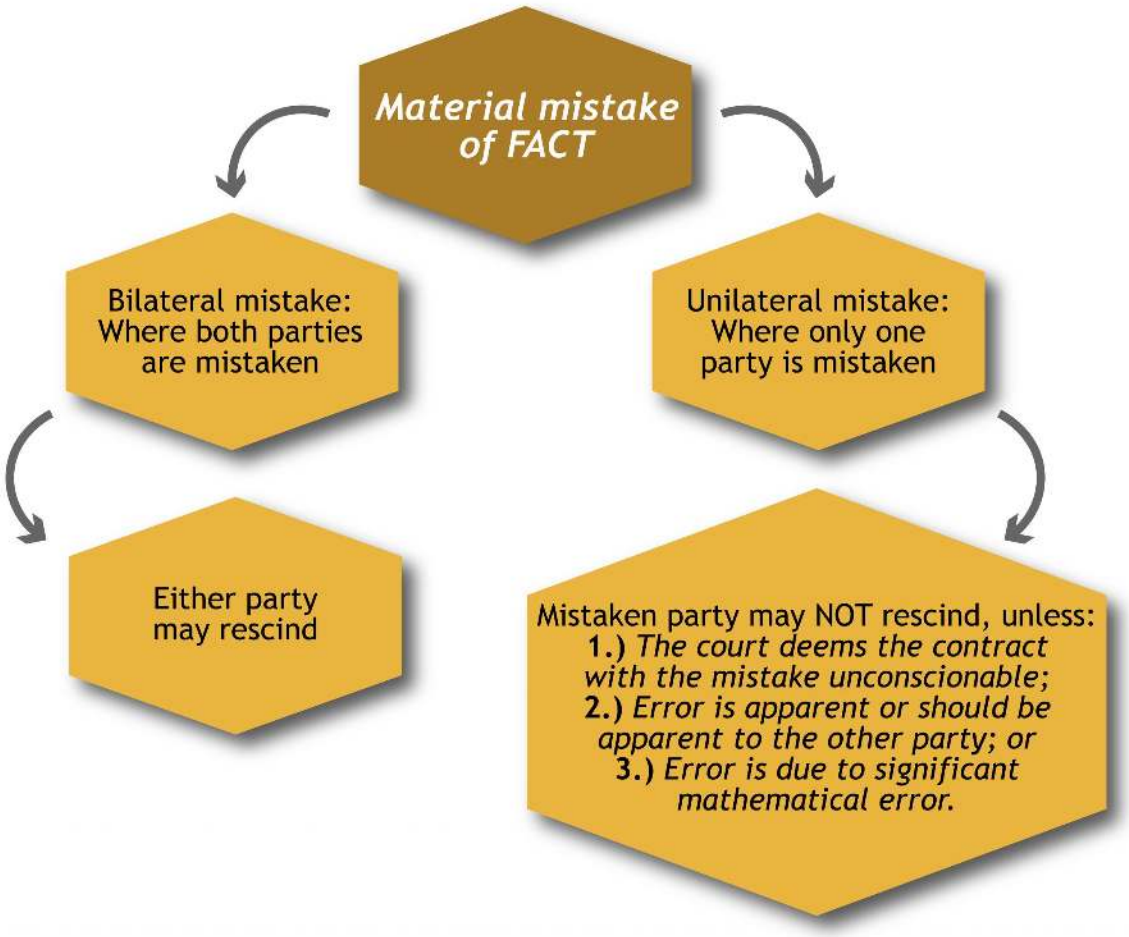
Mistake

In the context of contracts, a **mistake** is the situation in which the parties did not mean the same thing or when one or both parties formed untrue conclusions about the subject matter of the contract. In other words, a mistake is an erroneous belief.

Mutual mistake refers to something that is a mistake by both parties that relates to an essential term of the contract. For example, a contract to buy property that is not actually owned by the seller would be a mutual mistake, if the seller believed in good faith that he owned the property. When mutual mistakes occur, either party may rescind the contract.

Unilateral mistake occurs when only one party is laboring under a mistake. Mistake does not mean bad bargaining. Courts will not step in to save parties from bad bargaining absent evidence of undue influence or unconscionability. In general, parties cannot rescind the contract when unilateral mistakes occur except when the mistake makes the contract unconscionable, the error is apparent to the other party, or when significant mathematical errors occur.

Figure 10.1 Types of Mistakes Affecting Contracts and Their Remedies



Misrepresentation and Fraud

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. Fraud may also be a basis for criminal charges, depending on the circumstances leading to the contract.

Commercial impracticability

Commercial impracticability is a defense that can be used when fulfilling a contract has become extraordinarily difficult or unfair for one party. For example, a sales contract relating to the sale of goods destroyed by a natural disaster would fall under this defense. It becomes impossible for the seller to deliver goods that no longer exist, and would be unfair to enforce damages against the seller for breach of contract. This is also called **frustration of purpose** or **impossibility** in some jurisdictions.

Bankruptcy

Sometimes a party to a contract files for **bankruptcy** protection. The bankruptcy court will determine which debts the bankrupt party must pay and which are dischargeable. Contract obligations are suspended temporarily through the bankruptcy 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 contract obligation is determined to be a dischargeable debt, then the debt will not have to be paid.

10.6 Assignment, Delegation, and Third Party Beneficiaries

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 violates public policy. Likewise, the duties imposed on a party may be transferred to another party by **delegation**, unless the contract expressly restricts delegation, there is a substantial interest in personal performance by the original party to the contract, or if delegation would violate public policy.

As a general rule, a party may assign contract rights without the consent of the other party. This is common in the construction industry where a general contractor may assign rights and delegate duties to subcontractors for specific work that needs to be performed under the main contract. For example, the general contractor may delegate the duty to perform electrical work to an electrician, as well as assign the right to be paid for the work performed.

In delegation and assignment, the original contracting party is not "off the hook" if it transfers its duties or rights to another party. For instance, a subtenant assumed the rights and duties imposed on the original tenant in a lease. If the subletting tenant does not pay the rent, the original tenant is still liable.

The way to excuse oneself from legal liability under a contract is through novation. **Novation** is essentially a new contract that transfers all rights and duties to a new party to the contract and releases the previous party from any further obligation. It is the procedure in which one party is dismissed completely from the contract because a third party is substituted. In this situation, the dismissed party no longer has any liability under the original contract. To be effective, all parties must agree to the novation.

Third Party Beneficiaries

Assignment and delegation under a contract should not be confused with rights of third party beneficiaries. A **third party beneficiary** is someone who is not a party to the contract but stands to benefit from it. Life insurance policies are a classic example of contracts with third party beneficiaries. The insurance company and the insured are parties to the contract. But the person who receives payment upon the death of the insured is the third party beneficiary.

Third party beneficiaries can either be intended or incidental. An **intended beneficiary** is someone who the parties intend to receive the benefit of the contract. For example, the named beneficiary of a life insurance policy. The **beneficiary** does not need to know about the contract to have his or her rights vest.

An **incidental beneficiary** is someone who benefits from a contract but was not intended by the parties to benefit. For example, if a business pays for a professional to landscape its property, the neighbors are incidental beneficiaries to the landscaping contract. They benefit from the improved appearance and property values, but the business did not enter the contract with an intent to benefit them. Incidental beneficiaries do not have a legally enforceable interest in the contract.

10.7 Parol Evidence Rule

Courts often must interpret the meaning of a contract. When the contract is written, courts will look within the "four corners" of the document and apply the contract as written. **The Parol Evidence Rule** is the principle that a writing intended by the parties to be a final embodiment of their agreement cannot be modified by evidence that adds to, varies, or contradicts the writing. This rule usually prevents a party from introducing evidence of negotiations that occurred before or while the agreement was being reduced to its final written form.

However, there are several important exceptions that allow oral statements to be admitted:

1. Subsequent modifications;
2. Evidence of intentional misrepresentations by a party;

3. Correcting errors in drafting;
4. Clarifying ambiguities and filling in gaps; and
5. Supplements to a partially integrated contract.

As a result of the parol evidence rule, businesses should do their due diligence to ensure any written contracts fully and adequately include the essential terms of their agreement.

10.8 Remedies

The four main remedies for breach of contract are damages, specific performance, rescission, and restitution. The purpose of contract remedies is to compensate the non-breaching party for the losses suffered. In other words, remedies must put the non-breaching party in the position it would have been if there had been no breach.

Damages

Damages are the money paid by one party to another to discharge a legal liability.

Types of Monetary Damages	**Purpose**
Compensatory	To make the non-breaching party "whole" as if breach did not occur
Consequential	To cover indirect but foreseeable losses flowing from the breach
Incidental	To cover direct losses flowing from the breach & to avoid further loss
Nominal	To recognize legal breach although no actual damages resulted
Punitive	To punish and deter future wrongful behavior; only available if breach itself is a tort
Liquidated	To allow parties to determine value of contract in case of breach

Compensatory Damages

Compensatory damages are paid to compensate the non-breaching party for the loss suffered as a result of the breach. It is the general category of damages awarded to make the party whole. Compensatory damages include out-of-pocket losses and costs associated with the loss of the bargain. They are the primary damages in contract breach cases and are a direct, foreseeable result of the breach of contract.

Consequential Damages

A basic principle of contract law is that a person injured by breach of contract is not entitled to compensation unless the breaching party, at the time the contract was made, had reason to foresee the loss as a probable result of the breach.

Consequential damages are damages that flow as a foreseeable but indirect result of the breach of contract. For example, a roofer takes longer to fix a leaky roof than specified in a contract. The delay results in a retailer remaining closed for an additional week until the roof is repaired. The loss of sales from that week are consequential damages.

Consequential damages often include:

- Loss of profits due to the interruption of normal business practices;
- Loss of customers due to delays or cancellations; and
- Cost of replacement goods or services.

Incidental Damages

Incidental damages are damages that are paid to the non-breaching party in an attempt to avoid further loss on account of the breach. These damages include additional costs incurred by the non-breaching party after the breach in a reasonable attempt to avoid further loss, even if that attempt was unsuccessful.

For example, an electrician contracts to install light fixtures in a warehouse within seven days. The electrician enters into a purchase agreement with a supplier to buy the fixtures which are to be delivered within three days. On the fifth day, the supplier notifies the electrician that it cannot fill the order, breaching the contract. Because he cannot fulfill his contract with another supplier in time, the electrician breaches his contract with the warehouse and has to refund the warehouse its money. The losses incurred by the electrician to the warehouse are a direct result of the supplier's breach of contract, and are incidental damages.

Incidental costs often include:

- Inspection of items;
- Transportation or care of items;
- Expenses or commissions incurred in connection with incident or delay of items; and
- Storing of defective items until the supplier can retrieve them.

The difference between incidental and consequential damages is the cause of the expense or loss. Incidental damages are the direct result of one party's breach of contract. Consequential damages are more indirect, being incurred not as a result of the breach itself, but due to the end result of the breach.

Nominal Damages

If the breach of contract caused no actual loss, the non-breaching party may be awarded nominal damages. **Nominal damages** are a token amount of money paid when the breach has caused no actual loss. Nominal damages are often awarded symbolically by juries when they find legal liability but believe the breach was minor or could have been accommodated in another way. For example, a buyer could have purchased the same commodity at the same price without spending any extra time or money.

Punitive Damages

Punitive damages are awarded to a non-breaching party in excess of any loss suffered to punish the breaching party. Punitive damages are awarded when the defendant acted willfully and maliciously, and the purpose is to deter similar future bad conduct. Punitive damages are not usually available for breach of contract claims, unless the breach of contract itself constitutes a tort. In other words, punitive damages may be available when the contract breach itself is fraudulent or malicious. Punitive damages have been awarded against insurance companies that have refused to honor disability payments and that have acted in bad faith in denying legitimate claims.

Liquidated Damages

Liquidated damages are damages agreed upon by parties to a contract to be paid in the event of a breach. Because the parties are often in the best position to know the value of their contract, they can negotiate a fixed sum or method to calculate damages in the event of a breach. To be enforceable, liquidated damage provisions must apply equally to all parties, be negotiated fairly at the time the contract is executed, and must bear a reasonable relation to the probable damage in case of a breach.

Equitable Remedies for Breach of Contract

Equitable remedies involve a request for relief that does not include money damages. Equitable remedies are useful for when money does not provide adequate relief to the non-breaching party.

Equitable Remedy	Purpose	Description
Specific Performance	The object of the contract is unique & the loss cannot be easily compensated through money	Party must perform under terms of contract
Rescission	Contract was executed based on mutual mistake or fraud	Parties are put back into position they were in before contract was made
Restitution	Parties must return any benefit received	Benefit or item unjustly obtained is returned

Specific Performance

Specific performance is a judicial order directing a party to deliver the exact property (real or personal) under the terms of a contract. Specific performance is an alternative remedy to damages and may be issued at the discretion of the court. Specific

performance is granted when money damages are not an adequate remedy. For example, sale of specific real property (real estate is always unique), artwork, antiques, and heirlooms.

To warrant specific performance, a contract must be clear, definite, complete, and free from fraud and duress.

Specific performance is generally not available for service contracts. This is because ordering someone to perform a contract against their will is a type of involuntary servitude banned by the Thirteenth Amendment of the US Constitution. However, courts have occasionally entered injunctions prohibiting entertainers from performing at alternative venues until they perform at the venue under their original contract. These cases are in response to unethical forum shopping in the entertainment industry, and are very limited in nature.

Rescission

Rescission occurs when one party seeks to undo a contract and return to the position it was in before the contract was made. Rescission often occurs when fraud and mutual mistake occur and enforcing the contract would be unjust. Rescission may also be available when one party materially breaches the contract to such an extent that requiring the other party to perform would be unjust.

A party seeking rescission must notify the other party within a reasonable time after discovery of the facts that are the basis for rescission. The reason is that restoring the parties to their pre-contractual positions is easiest before too much time and performance has passed. Failure to rescind a contract in a timely manner may be held to affirm the contract or waive a breach of contract.

Restitution

Restitution is restoring property to the original owners. In other words, parties must return any benefit received under the contract. Therefore, only to the extent that the injured party conferred a benefit on the other party may the injured party be awarded restitution. Restitution often follows rescission of a contract. The purpose of restitution is to prevent a party from being unjustly enriched when a contract has been legally annulled.

10.9 Concluding Thoughts

Contracts are a fundamental part of business. It is important to understand how contracts are formed, performed, and executed in order to be successful. This understanding also includes understanding what performance is required, what defenses are available when someone breaches a contract, and what remedies are available in the event of a breach.

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12.1: Introduction

Although businesses tend to use the terms “agreement” and “contract” interchangeably, legally the terms have very different meanings. An **agreement** is a mutual understanding between two or more parties about their rights and duties toward each other. A **contract** is a legally enforceable agreement between two or more parties. All contracts are agreements, but not all agreements are contracts.

When contracts are broken, or breached, the injured party can seek damages. In contracts, this usually means an amount that would make that party whole again.

Generally speaking, contracts are a form of **private law**, because the terms of the contract are binding on the parties to the contract but not anyone else. 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.

Contracts may restrict parties’ future activity. For example, a non-compete clause in an employment contract may be enforceable in the future against an employee after termination of employment.

However, contracts that are illegal or against public policy are not enforceable.

Contract law performs three significant economic functions:

1. It helps individuals and businesses exchange goods and services efficiently.
2. It reduces the costs of economic transactions because parties do not need to negotiate a variety of rules and terms with each separate transaction.
3. It alerts the parties to problems that have arisen in the past, making it easier to avoid potential pitfalls.

Counselor’s Corner

We live in a world of contracts, which are the bread and butter of business transactions. However, many consumers, employees, and small businesses are afraid to read and understand contracts. That fear allows others to take advantage of them. Take the time to read contracts provided to you. Ask questions about anything you don’t understand before you sign. Have the courage to revise and edit contracts to ensure your interests are protected. Or even write your own. It’s not hard and the more you do it, the more confidence you will have to negotiate business transactions and protect your interests. ~Darnell T., attorney

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12.2: Contract Elements

There are three required elements of a contract: offer, acceptance, and consideration. It is important to note that some states and legal scholars expand this list to include whether the subject matter is legal, whether the parties have capacity to enter into a contract, and whether the law requires the contract to be in writing to be enforceable. However, these are best understood as defenses to contract formation, especially in light of the fact that the only elements that all states agree on are offer, acceptance, and consideration.

Offer

All contracts start when an individual or business proposes a deal. It might involve buying or selling goods, performing services, or making an exchange. An **offer** is a conditional promise to do or refrain from doing something now or in the future. In other words, it is willingness to enter into a contract.

Offers can be formal or informal. In some industries, such as retail and restaurants, offers are often posted on menus, signs, and advertisements. For example, a sign hanging above a cash register listing menu items and their prices is the restaurant's offer to sell customers those items at those prices.

There are not a lot of legal requirements about what an offer must contain, but there are some things that cannot be a legal offer:

Type of Invalid Offers	Definition	Example
Illusory Promise	No offer exists because there is no duty to perform	"If I decide to buy a new car, I'll give you my old one."
Pre-existing Duty	A party cannot leverage an existing duty to get more out of someone else	"I agree to teach you business law for $100 even though you have already paid tuition for the course."
Forbearance	An offer cannot be a promise not to pursue a legal claim that is known to be invalid (Note: if the claim is valid, then forbearance may be a valid offer)	"I know the accident was completely my fault but I promise not to sue you."
Past Consideration	An offer cannot be based on past actions	I paint your house. Two months later you say that you will pay me $500 for doing it. If you change your mind and decide not to pay me, I cannot enforce your promise because it was in consideration of a past event.

Once made, offers can be terminated in a number of ways. An offer that has been properly communicated continues to exist until it:

1. Is rejected;
2. Is replaced by a counteroffer;
3. Lapses or expires;
4. Is revoked; or
5. Is terminated by operation of law.

Unless it states a specific time, an offer remains open for a reasonable time. A **lapsed offer** is an offer that is no longer valid because a reasonable time to accept it has expired. An expired coupon is an example of a lapsed offer.

Acceptance

To constitute an agreement, there must be an acceptance of the offer. Legally, **acceptance** is an implied or express act that shows willingness to be bound by the terms of an offer. To be effective, both parties must understand and agree to be bound by the contract.

Acceptance can be both express or implied. Express acceptance occurs when a party states that they accept the offer. Acceptance may be implied based on the parties' conduct. For example, a retailer offers to sell a product to consumers for the price listed on the shelf. A consumer may accept that offer by handing the cashier the item and money to pay for it. The consumer does not need to say anything to complete the transaction. But the consumer must do *something* to accept. Silence, without more (such as handing over payment), is not acceptance. This is because silence may be evidence that the consumer either does not know about the offer or has rejected it.

A common problem in the business community is knowing what constitutes acceptance and what is negotiation. If an acceptance changes, adds, or modifies terms of the offer, it is a **counter-offer** and no contract is formed. The original party may decide to accept, reject, or propose another offer as a result. Although this sounds straightforward, with today's fast-paced communications, parties may respond to part of an offer, negotiate various parts of the contract simultaneously, or agree to terms in installments. As a result, there may be confusion about what the full terms of a contract are.

Offer and acceptance form **mutual assent**, which is also called "meeting of the minds." This is the parties' intention to enter into a binding contract on the terms they agreed upon. If parties do not agree on the essential terms, then there can be no meeting of the minds to enter into a contract. This is the basis for many of the defenses to contract formation.

Consideration

Consideration is the bargained-for exchange of something of value that shows the parties intend to be bound by the contract. There are two elements to consideration:

1. Something of value
2. Is exchanged between the parties.

The "something" that is promised or delivered must be a legal detriment. A **legal detriment** is giving up a legal or property right.

Consideration may be concurrent or a promise to perform in the future. However, it cannot be "past consideration" based on something that has occurred before the formation of the current contract. In other words, an act or promise made before the current contract is not adequate consideration because it was not given in exchange for the current promise.

When bargained-for consideration is not present, a court may validate a promise based on promissory estoppel. **Promissory estoppel** is the principle that a promise made without consideration may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise, and the promisee actually relied on the promise to his or her detriment. Promissory estoppel is an equitable doctrine used as a substitute for consideration that allows the imposition of contractual liability to prevent unfairness.

To establish promissory estoppel, a party must show:

1. A definite promise;
2. The party making the promise should have expected that the other party would rely on the promise;
3. A reasonable person would have relied on the promise;
4. The party relied on the promise and it resulted in a substantial detriment; and
5. Basic justice and fairness require that the promise be enforced.

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12.3: Types of Contracts

Bilateral and Unilateral Contracts

In a **bilateral contract**, both parties make a promise of performance. These contracts are also called mutual or reciprocal contracts. Bilateral contracts are the most common form of contracts. They include ordering food in a restaurant, buying gas for vehicles, purchasing goods and services, etc.

A **unilateral contract**, on the other hand, is a contract where one party makes a promise that the other party can accept only by doing something. For example, a business offers a reward for information leading to the arrest of a thief. A person cannot collect the reward money by promising to give information–he or she must perform under the contract by providing the information.

Express and Implied Contracts

An **express contract** is a contract in words (orally or in writing) in which the terms are spelled out directly. The parties to an express contract, whether written or oral, clearly intend to make a legally enforceable agreement. For example, an agreement to buy a car for $1,000 and to take title next Monday is an express contract.

An **implied contract** is a contract that is inferred from the parties' actions. Although no discussion of terms took place, an implied contract exists if it is clear from the conduct of the parties that they have an agreement. 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.

Quasi-contract: Contract Implied in Law

Both express and implied contracts embody an actual agreement of the parties. A **quasi-contract**, by contrast, is an obligation imposed by law to avoid unjust enrichment of one person at the expense of another. In fact, a quasi-contract is not a contract at all. It is a judicial remedy in which the court decides what a contract should look like between the parties to prevent injustice. For example, a carpenter mistakenly believes a homeowner hired him to repair her porch, when it was actually the neighbor who hired him. One morning the carpenter arrives and begins work. Rather than stop him, the homeowner lets him proceed, excited to get her porch fixed for free. Although no contract exists because there was no offer, acceptance or consideration, the law will imply a contract between the carpenter and homeowner for the value of the work.

Enforceability

A contract that is fully enforceable and reflects the parties' intent is **valid**. Conversely, an **unenforceable contract** is a contract where the parties intend to form a valid bargain but the court declares that it cannot be enforced for legal reasons. For example, Ramesh owes Jai money, but Jai has waited too long to collect it and the statute of limitations has run out. The contract for repayment is unenforceable and Jai is out of luck unless Ramesh makes a new promise to pay or actually pays part of the debt.

An agreement that is lacking one of the legal elements of a contract is **void** because it never was a contract. In other words, it is not legally enforceable because it is not a contract at all. An agreement that is illegal is also void. For example, a promise to commit a crime in return for payment is void because neither side can enforce the agreement in court.

By contrast, a **voidable contract** is a contract that can be annulled. It is a contract that is unenforceable by one party but enforceable by the other. For example, a minor may "avoid" a contract with an adult; meaning the adult may not enforce the contract against the minor if the minor refuses to carry out the bargain. The adult must comply if the minor wishes the contract to be performed. A contract may be voidable by both parties if they are both minors. Usually, the parties to a voidable contract are entitled to be restored to their original position.

A voidable contract remains a valid contract until it is voided. Thus, a contract with a minor remains in force unless the minor decides he does not wish to be bound by it. When minors become adults, they have two choices:

1. **Ratify** the contract–that is, agree to be bound by it; or
2. **Disaffirm** the contract–that is, disavow or avoid it.

Ratification may be explicit or implicit. For example, by continuing to make payments or retaining goods for an unreasonable period of time, a party may ratify the contract. If a party has not disaffirmed the contract while still a minor, she may do so within a reasonable time after becoming an adult.

Degree of Completion

An **executory contract** is a contract that has yet to be completed. Most executory contracts are enforceable. If some, but not all, of the terms of the contract have been performed, the contract is called **partially executed**. A contract that has been completed or carried out fully by both parties is called an **executed contract**.

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12.4: Performance and Breach of Contract

Performance simply means undertaking the legal duties imposed by the terms of the contract.

But how do we know whether the contract terms have been performed? Sometimes it's easy to determine. For instance, if someone offers to sell his scooter for four hundred dollars, a purchaser agrees, and they exchange the scooter for the money, then the contract has been fully performed. A contract was formed, the parties performed their obligations under it (known as **complete performance**), and they are subsequently discharged from further duties arising under the contract. Complete performance results in an executed contract.

When a party fails to perform under the terms of the contract without a legally justifiable reason, the party is in **breach of contract**. Not all breach of contract situations give rise to litigation. Some breaches are minor and may be overlooked by parties, especially if there is a long-term business relationship between them. Others may be major and give rise to significant issues between the parties.

In a service contract, the standard used to judge performance is **substantial performance**. This means that the performing party acted in good faith and conveyed enough benefit to the other party under the contract that any breach may be remedied by money damages. A **material breach** in a service contract occurs when a party has not substantially performed under the terms of the contract. A **minor breach** occurs when the party has substantially performed but has not strictly performed.

Performance to the standard of **personal satisfaction** can be enforced if the contract expressly requires it. This means that contract performance is evaluated 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. These contracts often occur in the entertainment industry, as well as the building of custom homes.

Conditions

A **condition** is an act or event (other than the lapse of time) that must occur before performance under a contract becomes due. Conditions determine when a party must perform.

Type of Condition	Description
Condition precedent	A condition must occur before a party's performance is required
Concurrent condition	Each party's performance is dependent on the other party's performance
Subsequent condition	A condition follows the duty to perform that completely eliminates or discharges a duty to perform
Constructive condition	Equitable doctrine that serves as an implied-in-law condition to prevent injustice

A **condition precedent** is an act or event that must occur before a duty of immediate performance of a promise arises. For example, an inspection of property is a condition precedent to the sale of a home.

A **concurrent condition** occurs when mutually dependent conditions must be performed at the same time by the parties. For example, delivery of goods and payment in a cash sale are concurrent conditions.

A **subsequent condition** is an event that discharges a duty of performance that becomes absolute. They are rare and tend to occur in the insurance industry. For example, an insurance company may require notice within thirty days of a claim. The insurance company does not have a duty to pay until the insured gives notice. Notice is the subsequent condition that triggers the insurance company's performance.

A **constructive condition** is a condition contained in an essential contractual term that, though omitted by the parties from their agreement, a court has supplied as being reasonable in the circumstances. It is an equitable doctrine that serves to imply conditions to prevent injustice.

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12.5: Defenses to Contracts

A party may have a valid reason for **breaching**, or not performing, a contract. These reasons are known as defenses to contract. Many of the defenses to contracts go to the heart of whether an agreement ever existed. In other words, if a party does not voluntarily consent or there was no "meeting of the minds," then a valid contract was never formed.

Illegality

Illegal contracts are unenforceable because they are void. There are two common types of illegalities: (1) statutory violations, and (2) violations of public policy. An example of a statutory violation is where a company in the US wants to avoid import regulations and quotas by purchasing Cuban cigars through an intermediary in Mexico. If the US buyer pays the Mexican intermediary for the cigars but does not receive them, the buyer cannot sue the intermediary for breach of contract. The law will not provide a remedy to someone who intends to violate the law.

Examples of violations of public policy often occur in an employment context. An employer that tries to bind its employees to unreasonable non-compete agreements violates the public policy of freedom to work. Another common example is contracts with professionals who do not maintain a current license in their field. If they are not legally licensed for the work they perform, they are not entitled to payment for their services. Here, the public policy is that the law does not want to encourage a black market for services outside of government regulation.

Incapacity

If someone lacks mental capacity to understand the terms of the agreement, there cannot be a true meeting of the minds to form a contract. **Capacity** is the mental state of mind sufficient to understand that a contract is made and its legal consequences.

Incapacity can be permanent, such as from mental illness, physical illness, or insanity. Incapacity may also be temporary, such as being intoxicated, under the influence of drugs, or underage (i.e. under eighteen years old).

Undue Influence

Undue influence occurs when one party overpowers the free will of another by use of superior power or influence. In other words, it is unfair persuasion. Undue influence is not a normal level of persuasion. Rather, it occurs when a party agrees to a contract that they would not have otherwise consented to without the unreasonable pressure of the other party. For example, an elderly person who is isolated from others due to poor health and living conditions may be lonely and eager for company. If a caretaker exerted influence over the elder to the extent that he or she could no longer exercise free will, then undue influence occurs. Contracts and transactions in which elders transfer most or all of their wealth to others are frequently reviewed for undue influence.

Duress

Duress occurs when there is a threat to a person, family or property. Economic pressure may constitute duress if it is wrongful and oppressive. Cases involving duress often occur in emergency situations. For example, when someone is required to sign legal paperwork in an emergency room before receiving medical treatment for themselves or their children.

If a person enters into a contract under duress, he or she is able to get out of the contract after the emergency situation is over. Duress essentially overcomes a person's free will to voluntarily choose to enter into the contract.

Unconscionability

Unconscionability occurs 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. Common cases involving unconscionability claims occur when one party is an experienced business dealer, while the other party is an average consumer. If the business dealer uses a very small font and inserts terms into the contract in a way that intentionally misleads the consumer into signing on unfair terms, then the contract may be deemed unconscionable.

Statute of Frauds

The **Statute of Frauds** requires certain contracts to be in writing and signed to be enforceable. The Statute of Frauds originated in England in 1677 to prevent fraud when one party tries to claim a contract existed when it did not. The Statute of Frauds requires a written contract for:

1. Real property interests;
2. Marriage;
3. Payment of another's debt;
4. Contracts that cannot be completely performed within one year;
5. Contracts for the sale of goods of five hundred dollars or more; and
6. Acting as another's executor/administrator.

Statute of Limitations

The **statute of limitations** is an affirmative defense that can be raised by a defendant to argue that a lawsuit is being brought too late. This means that if a dispute arises under a contract, then the plaintiff must bring a lawsuit concerning that dispute within a certain time period. States have different statutes of limitations. If a contract has a choice of law provision, then that state's statute of limitations will apply to disputes related to the contract.

Mistake

In the context of contracts, a **mistake** is the situation in which the parties did not mean the same thing or when one or both parties formed untrue conclusions about the subject matter of the contract. In other words, a mistake is an erroneous belief.

Mutual mistake refers to something that is a mistake by both parties that relates to an essential term of the contract. For example, a contract to buy property that is not actually owned by the seller would be a mutual mistake, if the seller believed in good faith that he owned the property. When mutual mistakes occur, either party may rescind the contract.

Unilateral mistake occurs when only one party is laboring under a mistake. Mistake does not mean bad bargaining. Courts will not step in to save parties from bad bargaining absent evidence of undue influence or unconscionability. In general, parties cannot rescind the contract when unilateral mistakes occur except when the mistake makes the contract unconscionable, the error is apparent to the other party, or when significant mathematical errors occur.

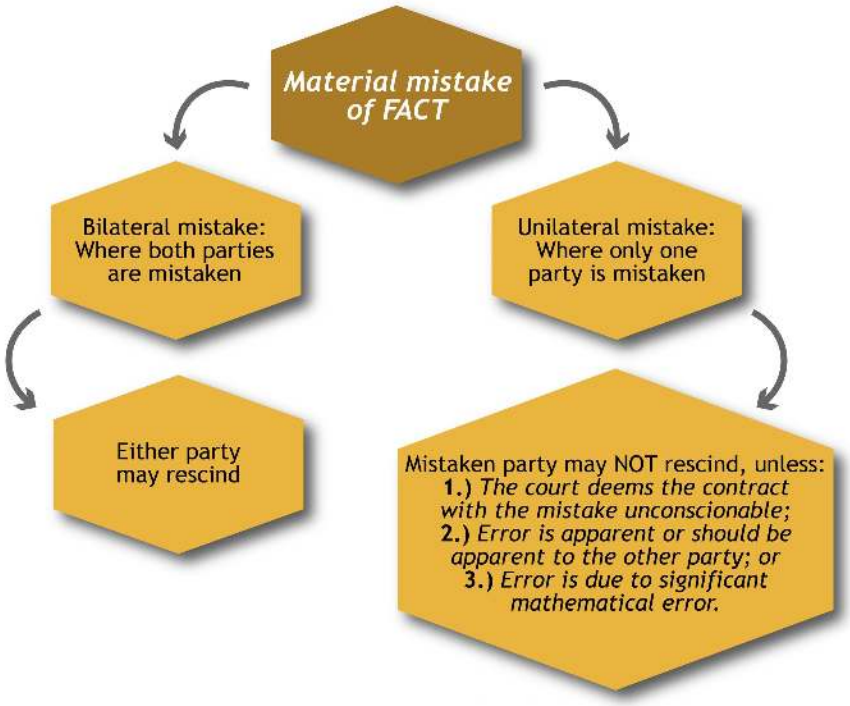


Figure 10.1 Types of Mistakes Affecting Contracts and Their Remedies

Misrepresentation and Fraud

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. Fraud may also be a basis for criminal charges, depending on the circumstances leading to the contract.

Commercial impracticability

Commercial impracticability is a defense that can be used when fulfilling a contract has become extraordinarily difficult or unfair for one party. For example, a sales contract relating to the sale of goods destroyed by a natural disaster would fall under this defense. It becomes impossible for the seller to deliver goods that no longer exist, and would be unfair to enforce damages against the seller for breach of contract. This is also called **frustration of purpose** or **impossibility** in some jurisdictions.

Bankruptcy

Sometimes a party to a contract files for **bankruptcy** protection. The bankruptcy court will determine which debts the bankrupt party must pay and which are dischargeable. Contract obligations are suspended temporarily through the bankruptcy 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 contract obligation is determined to be a dischargeable debt, then the debt will not have to be paid.

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12.6: Assignment, Delegation, and Third Party Beneficiaries

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 violates public policy. Likewise, the duties imposed on a party may be transferred to another party by **delegation**, unless the contract expressly restricts delegation, there is a substantial interest in personal performance by the original party to the contract, or if delegation would violate public policy.

As a general rule, a party may assign contract rights without the consent of the other party. This is common in the construction industry where a general contractor may assign rights and delegate duties to subcontractors for specific work that needs to be performed under the main contract. For example, the general contractor may delegate the duty to perform electrical work to an electrician, as well as assign the right to be paid for the work performed.

In delegation and assignment, the original contracting party is not “off the hook” if it transfers its duties or rights to another party. For instance, a subtenant assumed the rights and duties imposed on the original tenant in a lease. If the subletting tenant does not pay the rent, the original tenant is still liable.

The way to excuse oneself from legal liability under a contract is through novation. **Novation** is essentially a new contract that transfers all rights and duties to a new party to the contract and releases the previous party from any further obligation. It is the procedure in which one party is dismissed completely from the contract because a third party is substituted. In this situation, the dismissed party no longer has any liability under the original contract. To be effective, all parties must agree to the novation.

Third Party Beneficiaries

Assignment and delegation under a contract should not be confused with rights of third party beneficiaries. A **third party beneficiary** is someone who is not a party to the contract but stands to benefit from it. Life insurance policies are a classic example of contracts with third party beneficiaries. The insurance company and the insured are parties to the contract. But the person who receives payment upon the death of the insured is the third party beneficiary.

Third party beneficiaries can either be intended or incidental. An **intended beneficiary** is someone who the parties intend to receive the benefit of the contract. For example, the named beneficiary of a life insurance policy. The **beneficiary** does not need to know about the contract to have his or her rights vest.

An **incidental beneficiary** is someone who benefits from a contract but was not intended by the parties to benefit. For example, if a business pays for a professional to landscape its property, the neighbors are incidental beneficiaries to the landscaping contract. They benefit from the improved appearance and property values, but the business did not enter the contract with an intent to benefit them. Incidental beneficiaries do not have a legally enforceable interest in the contract.

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12.7: Parol Evidence Rule

Courts often must interpret the meaning of a contract. When the contract is written, courts will look within the “four corners” of the document and apply the contract as written. **The Parol Evidence Rule** is the principle that a writing intended by the parties to be a final embodiment of their agreement cannot be modified by evidence that adds to, varies, or contradicts the writing. This rule usually prevents a party from introducing evidence of negotiations that occurred before or while the agreement was being reduced to its final written form.

However, there are several important exceptions that allow oral statements to be admitted:

1. Subsequent modifications;
2. Evidence of intentional misrepresentations by a party;
3. Correcting errors in drafting;
4. Clarifying ambiguities and filling in gaps; and
5. Supplements to a partially integrated contract.

As a result of the parol evidence rule, businesses should do their due diligence to ensure any written contracts fully and adequately include the essential terms of their agreement.

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12.8: Remedies

The four main remedies for breach of contract are damages, specific performance, rescission, and restitution. The purpose of contract remedies is to compensate the non-breaching party for the losses suffered. In other words, remedies must put the non-breaching party in the position it would have been if there had been no breach.

Damages

Damages are the money paid by one party to another to discharge a legal liability.

Criminal Law	Civil Law
Compensatory	To make the non-breaching party "whole" as if breach did not occur
Consequential	To cover indirect but foreseeable losses flowing from the breach
Incidental	To cover direct losses flowing from the breach & to avoid further loss
Nominal	To recognize legal breach although no actual damages resulted
Punitive	To punish and deter future wrongful behavior; only available if breach itself is a tort
Liquidated	To allow parties to determine value of contract in case of breach

Compensatory Damages

Compensatory damages are paid to compensate the non-breaching party for the loss suffered as a result of the breach. It is the general category of damages awarded to make the party whole. Compensatory damages include out-of-pocket losses and costs associated with the loss of the bargain. They are the primary damages in contract breach cases and are a direct, foreseeable result of the breach of contract.

Consequential Damages

A basic principle of contract law is that a person injured by breach of contract is not entitled to compensation unless the breaching party, at the time the contract was made, had reason to foresee the loss as a probable result of the breach.

Consequential damages are damages that flow as a foreseeable but indirect result of the breach of contract. For example, a roofer takes longer to fix a leaky roof than specified in a contract. The delay results in a retailer remaining closed for an additional week until the roof is repaired. The loss of sales from that week are consequential damages.

Consequential damages often include:

- Loss of profits due to the interruption of normal business practices;
- Loss of customers due to delays or cancellations; and
- Cost of replacement goods or services.

Incidental Damages

Incidental damages are damages that are paid to the non-breaching party in an attempt to avoid further loss on account of the breach. These damages include additional costs incurred by the non-breaching party after the breach in a reasonable attempt to avoid further loss, even if that attempt was unsuccessful.

For example, an electrician contracts to install light fixtures in a warehouse within seven days. The electrician enters into a purchase agreement with a supplier to buy the fixtures which are to be delivered within three days. On the fifth day, the supplier notifies the electrician that it cannot fill the order, breaching the contract. Because he cannot fulfill his contract with another supplier in time, the electrician breaches his contract with the warehouse and has to refund the warehouse its money. The losses incurred by the electrician to the warehouse are a direct result of the supplier's breach of contract, and are incidental damages.

Incidental costs often include:

- Inspection of items;
- Transportation or care of items;
- Expenses or commissions incurred in connection with incident or delay of items; and
- Storing of defective items until the supplier can retrieve them.

The difference between incidental and consequential damages is the cause of the expense or loss. Incidental damages are the direct result of one party's breach of contract. Consequential damages are more indirect, being incurred not as a result of the breach itself, but due to the end result of the breach.

Nominal Damages

If the breach of contract caused no actual loss, the non-breaching party may be awarded nominal damages. **Nominal damages** are a token amount of money paid when the breach has caused no actual loss. Nominal damages are often awarded symbolically by juries when they find legal liability but believe the breach was minor or could have been accommodated in another way. For example, a buyer could have purchased the same commodity at the same price without spending any extra time or money.

Punitive Damages

Punitive damages are awarded to a non-breaching party in excess of any loss suffered to punish the breaching party. Punitive damages are awarded when the defendant acted willfully and maliciously, and the purpose is to deter similar future bad conduct. Punitive damages are not usually available for breach of contract claims, unless the breach of contract itself constitutes a tort. In other words, punitive damages may be available when the contract breach itself is fraudulent or malicious. Punitive damages have been awarded against insurance companies that have refused to honor disability payments and that have acted in bad faith in denying legitimate claims.

Liquidated Damages

Liquidated damages are damages agreed upon by parties to a contract to be paid in the event of a breach. Because the parties are often in the best position to know the value of their contract, they can negotiate a fixed sum or method to calculate damages in the event of a breach. To be enforceable, liquidated damage provisions must apply equally to all parties, be negotiated fairly at the time the contract is executed, and must bear a reasonable relation to the probable damage in case of a breach.

Equitable Remedies for Breach of Contract

Equitable remedies involve a request for relief that does not include money damages. Equitable remedies are useful for when money does not provide adequate relief to the non-breaching party.

Equitable Remedy	Purpose	Description
Specific Performance	The object of the contract is unique & the loss cannot be easily compensated through money	Party must perform under terms of contract
Rescission	Contract was executed based on mutual mistake or fraud	Parties are put back into position they were in before contract was made
Restitution	Parties must return any benefit received	Benefit or item unjustly obtained is returned

Specific Performance

Specific performance is a judicial order directing a party to deliver the exact property (real or personal) under the terms of a contract. Specific performance is an alternative remedy to damages and may be issued at the discretion of the court. Specific performance is granted when money damages are not an adequate remedy. For example, sale of specific real property (real estate is always unique), artwork, antiques, and heirlooms.

To warrant specific performance, a contract must be clear, definite, complete, and free from fraud and duress.

Specific performance is generally not available for service contracts. This is because ordering someone to perform a contract against their will is a type of involuntary servitude banned by the Thirteenth Amendment of the US Constitution. However, courts have occasionally entered injunctions prohibiting entertainers from performing at alternative venues until they perform at the venue under their original contract. These cases are in response to unethical forum shopping in the entertainment industry, and are very limited in nature.

Rescission

Rescission occurs when one party seeks to undo a contract and return to the position it was in before the contract was made. Rescission often occurs when fraud and mutual mistake occur and enforcing the contract would be unjust. Rescission may also be available when one party materially breaches the contract to such an extent that requiring the other party to perform would be unjust.

A party seeking rescission must notify the other party within a reasonable time after discovery of the facts that are the basis for rescission. The reason is that restoring the parties to their pre-contractual positions is easiest before too much time and performance has passed. Failure to rescind a contract in a timely manner may be held to affirm the contract or waive a breach of contract.

Restitution

Restitution is restoring property to the original owners. In other words, parties must return any benefit received under the contract. Therefore, only to the extent that the injured party conferred a benefit on the other party may the injured party be awarded restitution. Restitution often follows rescission of a contract. The purpose of restitution is to prevent a party from being unjustly enriched when a contract has been legally annulled.

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12.9: Concluding Thoughts

Contracts are a fundamental part of business. It is important to understand how contracts are formed, performed, and executed in order to be successful. This understanding also includes understanding what performance is required, what defenses are available when someone breaches a contract, and what remedies are available in the event of a breach.

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13: Sales Contracts

11.1 Introduction

LEARNING OBJECTIVES

1. Explore the differences between the Uniform Commercial Code and common law contract principles.
2. Understand important provisions of the Uniform Commercial Code and how they apply to merchants who sell goods.
3. Learn when the Uniform Commercial Code applies to mixed contracts.

One of the drawbacks of federalism is that states can implement different laws. This was a serious problem as the US economy grew beyond local and state-based industries to economies of scale during the Twentieth Century because it hampered economic growth. In response, business leaders demanded consistent laws to facilitate trade across the nation, especially for the sale of goods across state lines.

The **Uniform Commercial Code (UCC)** is a proposed set of laws developed by legal experts and business leaders to govern commercial transactions, including sale of goods, secured transactions, and negotiable instruments. The UCC was created in 1952 and its advocates lobbied the states and territories to adopt it. The UCC has been adopted in some form by all fifty states, the District of Columbia, and US territories. Interestingly, it is the only "national" law not enacted by Congress.

This chapter will focus on important provisions that relate to sales contracts that have been adopted by most, if not all, states.

Counselor's Corner When writing something for work, I offer the following advice. First, take time to review and edit your writing. You will be surprised at the number of typos that can be discovered when you give your work fresh eyes. Don't be afraid to reach out to others to review your work as well. Excellence in writing will help to convey your message clearly and credibly. Second, write with honesty. If your reader doubts the sincerity of your work, the message you are trying to convey will be lost. The strongest advocates I have encountered are the most honest ones. Third, be clear and concise. Tell your reader a story but give them the information they need in an organized fashion. ~Tiffany M., attorney

11.2 Scope of the UCC

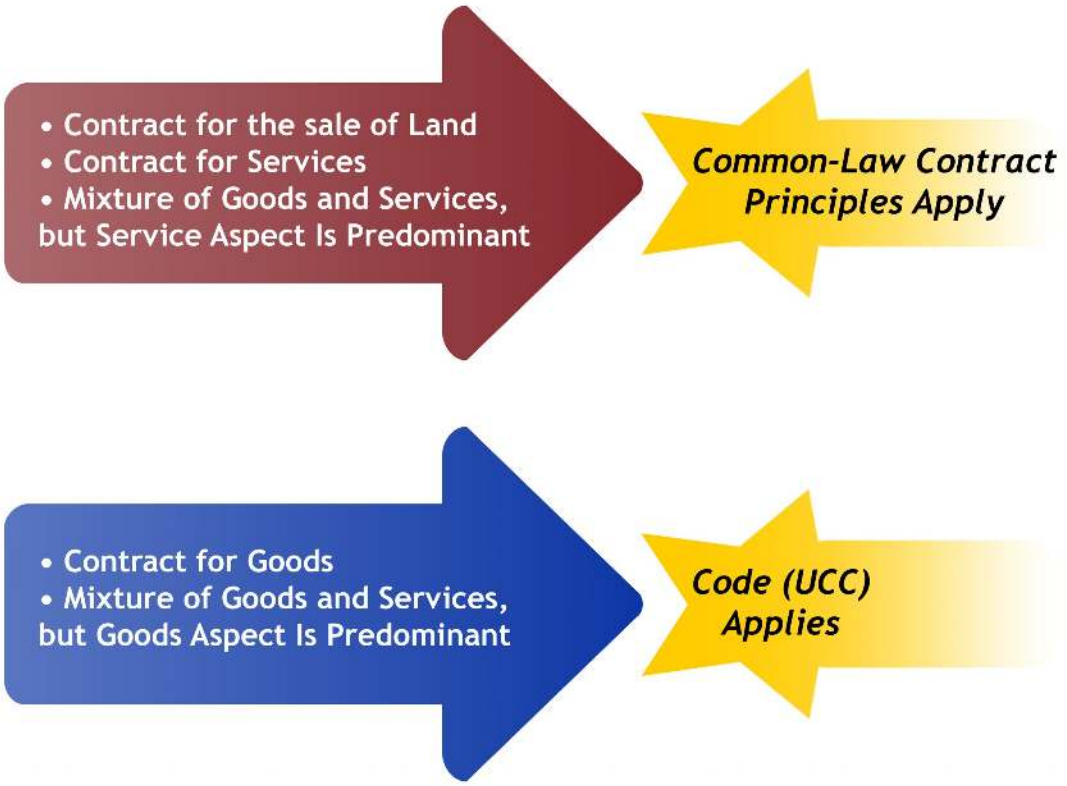
The UCC deals with commercial transactions from start to finish. The power of the UCC is that if the parties do not have a contract with express terms, then the UCC "fills the gaps" with legal requirements. For example, if the parties do not negotiate the terms of delivery, then the UCC states where and when delivery should occur. This is incredibly beneficial to businesses because it provides legal certainty and consistency across jurisdictions. If parties have a dispute, or unforeseen circumstances result in a breach of contract, the parties can resolve the problem without having to litigate the issue in court. This saves businesses a lot of time, money and resources, as well as helps them maintain good working relationships.

The UCC also addresses four important problems that merchants struggled with under the common law:

Problem	Common Law	UCC	Example
Contract Formation	Mirror Image Rule: Offer must be followed by acceptance showing meeting of the minds on all essential terms	Contract can be made in any manner that shows agreement and some terms, including price and time of delivery, may be left open (§2-204 & §2-305)	Jimena writes Ahn that she needs a new computer. Ahn delivers the computer and Jimena starts to use it. Under the common law, there is no contract because price was not discussed. Under the UCC a contract exists for a reasonable price.
Required Writing	All essential terms must be in writing	Any writing that intends to be a contract is enforceable; "merchant" exception can create a contract against party that does not object to writing within ten days (§2-201)	Home Depot sends a purchase order to a wholesaler. The wholesaler receives the order but does not respond. Under the common law, no contract exists. Under the UCC, a contract exists after ten days that Home Depot may enforce against the wholesaler.
Additional Terms	An acceptance with any additional terms is a counteroffer	Additional and different terms are not necessarily counteroffers, may just be part of negotiation process (§2-207)	A florist sends a preprinted order form to buy specific supplies from a manufacturer for a stated price. The manufacturer responds with its own preprinted form accepting the order but adding the term that unpaid balances incur interest. Under the common law, the additional term is a counteroffer and no contract is formed until the florist accepts it. Under the UCC, there is a valid contract that includes the interest term.
Modification	To be valid, a modification must be supported by new consideration	A modification does not need to be supported by new consideration (§2-209)	Fred Farmer agrees to sell produce to Aponi for her restaurant. They agree to all essential terms, including goods, price, and delivery. The next day a hurricane floods the interstate doubling the delivery costs. Fred calls Aponi who agrees to pay half of the increased cost. Under the common law, the modification is void. Under the UCC, the modification is enforceable.

A common problem is determining when the UCC applies. The UCC does not apply to contracts related to the sale of land, intangible personal property, construction, or for services. The UCC applies to the sale of **goods**, which the Code defines as any moveable physical object except for money and securities. In other words, goods are tangible personal property.

Figure 11.1 Determination of when the UCC Applies to Sales Transactions



Mixed contracts are for both the sale of goods and services. For example, a contract for the sale of a dishwasher that includes the service of installation is a mixed contract. The UCC only applies to mixed contracts when the primary purpose of the contract is the sale of goods. In the dishwasher example, the UCC applies because installation would not occur without the sale of the dishwasher.

The UCC also does not apply if none of the parties are a merchant. In other words, the sale of goods between individuals is governed by the common law. If a sales transaction involves a merchant, then the UCC usually applies. A **merchant** is someone who routinely deals in the goods involved in the transaction or who, by his or her occupation, holds himself or herself out as having special knowledge with respect to the goods. Suppliers of services are not merchants.

The UCC provides merchants with rules that facilitate their business needs. For example, contract formation is more informal and flexible than under the common law. However, the UCC often holds merchants to a higher standard of conduct than non-merchants. Merchants are required to act in good faith and to observe reasonable commercial standards of fair dealing.

11.3 Sales Contract Formation

The common law expects parties to form a contract by making an offer, with an acceptance that mirrors the offer and includes all material terms. Modern business transactions, however, frequently do not follow that pattern. As a result, UCC §2-204 provides that a contract may be formed in any manner that shows the parties reached an agreement.

The terms of sales contracts are supplied by three sources:

1. The express agreement of the parties;
2. Course of dealing, usage of trade, and course of performance; and

3. The UCC.

Express Agreement

The general rule is that parties are free to make their own sales contract. When parties agree on terms–especially for quality, quantity, price, delivery and payment–those terms control over UCC provisions. The parties' freedom to contract, however, is not limitless. Parties cannot disclaim their obligation of good faith, diligence, and due care. Similarly, liquidated damages provisions must be based on the value of the contract and cannot be a penalty for breach of contract. Further, limitations on consequential damages cannot be unconscionable.

Course of Dealing, Usage of Trade & Course of Performance

The parties' agreement may be based on their actions. **Course of dealing** is an established pattern of prior conduct between the parties to a particular transaction. If a dispute arises, the parties' course of dealing can be used as evidence of how they intended to carry out the transaction. In other words, the current contract is interpreted based on past contracts.

Course of performance relates to the conduct of the parties under the contract in question after its formation. It occurs when a contract involves repeated performance and looks at how the parties have acted when performing this particular contract, not contracts in the past.

Usage of trade is a practice or custom in a particular trade used so frequently that it justifies the expectation that it will be followed in the current transaction. It is industry standards and customs related to a particular industry.

UCC Provisions

When sales contracts do not have all the necessary terms, the UCC "fills in the gaps" of the contract. The most important UCC gap-filler provisions relate to price, quantity, delivery, and time of performance.

Figure 11.2 UCC Gap-Filler Provisions

Provision	Subject	Description
§2-305	Price	Price can be left open to be fixed at later time
		Reasonable price determined upon delivery "Output" and "Requirement" amounts can be determined at later time
§2-306	Quantity	No quantity that is unreasonably disproportionate to the estimate will be enforced
		Reasonable amount in keeping with normal or prior comparable output or requirements is implied
§2-507	Delivery	Delivery occurs at seller's place of business unless contract provides otherwise
§2-308/ §2-309	Time	Reasonable time for performance

Provision	Subject	Description
§2-305	Price	Price can be left open to be fixed at later time; Reasonable price determined upon delivery
§2-306	Quantity	"Output" and "Requirement" amounts can be determined at a later time; No quantity that is unreasonably disproportionate to the estimate will be enforced; Reasonable amount in keeping with normal or prior comparable output or requirements is implied
§2-507 & §2-308	Delivery	Delivery occurs at seller's place of business unless contract provides otherwise
§2-309	Time	Reasonable time for performance

When these sources of contract terms are in conflict, the UCC applies the following hierarchy:

1. Express terms;
2. Course of performance;
3. Course of dealing;
4. Usage of trade; and
5. UCC gap-filler provisions.

The logic is that the parties are free to contract the terms they would like. In absence of an express agreement, the parties' conduct shows their intent. In practical terms, usage of trade and UCC provisions often go hand-in-hand. For example, what constitutes "reasonable time" for performance is often based on relevant industry standards. Although the UCC identifies a hierarchy, in practice it is not rigidly applied by the courts when determining usage of trade and UCC provisions.

Additional and Different Terms

Under UCC §2-207, an acceptance that adds or alters terms will often create a contract. Unlike the common law that treats modifications as a counter-offer, the UCC has a more flexible concept of acceptance. This is to address the "battle of the forms" that happens when merchants buy and sell goods with pre-printed forms. Frequently buyers use pre-printed forms to place an order that are then acknowledged by the seller on its own pre-printed forms. These forms typically contain language favorable to the party sending it and rarely agree.

Section 2-207 still requires the parties to intend to create a contract. If the differing forms show that the parties never reached an agreement, then no contract exists.

However, if the acceptance contains an additional term, then a contract is usually formed. An **additional term** is a proposed contract term that addresses issues not included in the offer. Additional terms expand the offer to cover more essential terms to ensure a meeting of the minds.

If both parties are merchants, the additional terms usually become part of the contract unless:

1. The offer states that it cannot be accepted with additional or different terms;
2. The additional terms materially alter the offer; or
3. The party making the offer promptly rejects the additional terms.

A **different term** is a proposed contract term that contradicts the term(s) in the offer. Under the UCC, different terms cancel each other out. In most states, different terms are replaced by UCC gap-filler provisions.

11.4 Performance

A seller is expected to deliver what the buyer ordered. **Conforming goods** meet contractual specifications and satisfy performance requirements. **Non-conforming goods** are goods that fail to meet contractual specifications, allowing the buyer to reject the goods or to revoke acceptance.

A buyer has the right to inspect the goods before paying or accepting them. A buyer may also reject non-conforming goods by notifying the seller within a reasonable time.

If a buyer rejects the goods, the seller has the **right to cure**, which is the right to deliver conforming goods before the contract deadline. The UCC also allows the right to cure after the contract deadline in some situations. If the seller delivers conforming goods, then it is entitled to full payment under the contract.

If the seller breaches the contract, the buyer is entitled to cover. **Cover** is obtaining reasonable substitute goods because another party failed to perform under a contract. If the seller obtains reasonable substitute goods, the seller is entitled to the difference between the contract price and its cover price, plus incidental and consequential damages, minus expenses saved.

If the buyer breaches the contract, the seller may refuse to deliver the goods. If a buyer refuses to accept or pay for goods without justification, the seller may resell them to another party. When the resale is commercially reasonable, the seller may recover the difference between the resale price and the contract price, plus incidental damages, minus expenses saved.

If the buyer has accepted the goods and refuses to pay, or if the goods are conforming but resale is impossible, the seller may sue the buyer for the contract price. This is common when the buyer orders goods with unique specifications.

11.5 Warranties

A **warranty** is a contractual assurance that goods will meet a certain standard. An **express warranty** is a guarantee, created by the words or actions of the seller, that goods will meet certain standards. Under the UCC, a seller may create an express warranty in three ways:

1. With an affirmation of a fact or a promise;
2. With a description of the goods; or
3. With a sample or model.

To constitute a warranty, the seller's words or actions must be part of the basis of the bargain. For example, if a salesperson says that a car's timing belt was just replaced and will not need to be replaced for another 100,000 miles, and the buyer relied on that statement when deciding to buy the car, then the salesperson's statement becomes an express warranty.

An **implied warranty** is a guarantee created by the UCC and imposed on the seller of goods. There are two main implied warranties: merchantability and fitness for a particular purpose.

The **implied warranty of merchantability** is a warranty that the goods are fit for the ordinary purposes for which they are used. To disclaim this warranty, a merchant must use the term "merchantability." The novel or unusual use of goods is not protected by this warranty. If a buyer uses goods for something other than their intended purpose, the warranty does not apply.

The **implied warranty of fitness for a particular purpose** is a warranty that the property is suitable for the buyer's special purpose. For the warranty to apply, the seller must know what the buyer's purpose is and the buyer must rely on the seller's judgment that the goods meet the buyer's needs.

11.6 Concluding Thoughts

The UCC is a national law that was proposed by legal experts and business leaders to address the need for consistent laws related to the sale of goods across state lines. The UCC also applies to secured transactions and negotiable instruments, which are areas beyond the scope of this book. For individuals and businesses who buy or sell goods with merchants, it is important to understand how the UCC fills in gaps with terms that are not expressly contained in a contract, as well as to understand applicable warranties. The flexibility of the UCC facilitates business by making commercial transactions more consistent and predictable.

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13.1: Introduction

One of the drawbacks of federalism is that states can implement different laws. This was a serious problem as the US economy grew beyond local and state-based industries to economies of scale during the Twentieth Century because it hampered economic growth. In response, business leaders demanded consistent laws to facilitate trade across the nation, especially for the sale of goods across state lines.

The **Uniform Commercial Code (UCC)** is a proposed set of laws developed by legal experts and business leaders to govern commercial transactions, including sale of goods, secured transactions, and negotiable instruments. The UCC was created in 1952 and its advocates lobbied the states and territories to adopt it. The UCC has been adopted in some form by all fifty states, the District of Columbia, and US territories. Interestingly, it is the only "national" law not enacted by Congress.

This chapter will focus on important provisions that relate to sales contracts that have been adopted by most, if not all, states.

Counselor's Corner

When writing something for work, I offer the following advice. First, take time to review and edit your writing. You will be surprised at the number of typos that can be discovered when you give your work fresh eyes. Don't be afraid to reach out to others to review your work as well. Excellence in writing will help to convey your message clearly and credibly. Second, write with honesty. If your reader doubts the sincerity of your work, the message you are trying to convey will be lost. The strongest advocates I have encountered are the most honest ones. Third, be clear and concise. Tell your reader a story but give them the information they need in an organized fashion. ~Tiffany M., attorney

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13.2: Scope of the UCC

The UCC deals with commercial transactions from start to finish. The power of the UCC is that if the parties do not have a contract with express terms, then the UCC "fills the gaps" with legal requirements. For example, if the parties do not negotiate the terms of delivery, then the UCC states where and when delivery should occur. This is incredibly beneficial to businesses because it provides legal certainty and consistency across jurisdictions. If parties have a dispute, or unforeseen circumstances result in a breach of contract, the parties can resolve the problem without having to litigate the issue in court. This saves businesses a lot of time, money and resources, as well as helps them maintain good working relationships.

The UCC also addresses four important problems that merchants struggled with under the common law:

Problem	Common Law	UCC	Example
Contract Formation	Mirror Image Rule: Offer must be followed by acceptance showing meeting of the minds on all essential terms	Contract can be made in any manner that shows agreement and some terms, including price and time of delivery, may be left open (§2-204 & §2-305)	Jimena writes Ahn that she needs a new computer. Ahn delivers the computer and Jimena starts to use it. Under the common law, there is no contract because price was not discussed. Under the UCC a contract exists for a reasonable price.
Required Writing	All essential terms must be in writing	Any writing that intends to be a contract is enforceable; “merchant” exception can create a contract against party that does not object to writing within ten days (§2-201)	Home Depot sends a purchase order to a wholesaler. The wholesaler receives the order but does not respond. Under the common law, no contract exists. Under the UCC, a contract exists after ten days that Home Depot may enforce against the wholesaler.
Additional Terms	An acceptance with any additional terms is a counteroffer	Additional and different terms are not necessarily counteroffers, may just be part of negotiation process (§2-207)	A florist sends a preprinted order form to buy specific supplies from a manufacturer for a stated price. The manufacturer responds with its own preprinted form accepting the order but adding the term that unpaid balances incur interest. Under the common law, the additional term is a counteroffer and no contract is formed until the florist accepts it. Under the UCC, there is a valid contract that includes the interest term.
Modification	To be valid, a modification must be supported by new consideration	A modification does not need to be supported by new consideration (§2-209)	Fred Farmer agrees to sell produce to Aponi for her restaurant. They agree to all essential terms, including goods, price, and delivery. The next day a hurricane floods the interstate doubling the delivery costs. Fred calls Aponi who agrees to pay half of the increased cost. Under the common law, the modification is void. Under the UCC, the modification is enforceable.

A common problem is determining when the UCC applies. The UCC does not apply to contracts related to the sale of land, intangible personal property, construction, or for services. The UCC applies to the sale of **goods**, which the Code defines as any

moveable physical object except for money and securities. In other words, goods are tangible personal property.

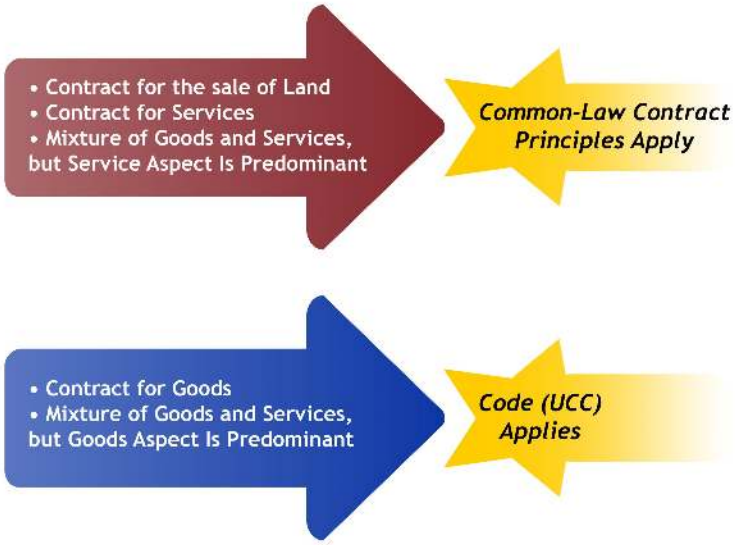


Figure 11.1 Determination of when the UCC Applies to Sales Transactions

Mixed contracts are for both the sale of goods and services. For example, a contract for the sale of a dishwasher that includes the service of installation is a mixed contract. The UCC only applies to mixed contracts when the primary purpose of the contract is the sale of goods. In the dishwasher example, the UCC applies because installation would not occur without the sale of the dishwasher.

The UCC also does not apply if none of the parties are a merchant. In other words, the sale of goods between individuals is governed by the common law. If a sales transaction involves a merchant, then the UCC usually applies. A **merchant** is someone who routinely deals in the goods involved in the transaction or who, by his or her occupation, holds himself or herself out as having special knowledge with respect to the goods. Suppliers of services are not merchants.

The UCC provides merchants with rules that facilitate their business needs. For example, contract formation is more informal and flexible than under the common law. However, the UCC often holds merchants to a higher standard of conduct than non-merchants. Merchants are required to act in good faith and to observe reasonable commercial standards of fair dealing.

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13.3: Sales Contract Formation

The common law expects parties to form a contract by making an offer, with an acceptance that mirrors the offer and includes all material terms. Modern business transactions, however, frequently do not follow that pattern. As a result, UCC §2-204 provides that a contract may be formed in any manner that shows the parties reached an agreement.

The terms of sales contracts are supplied by three sources:

1. The express agreement of the parties;
2. Course of dealing, usage of trade, and course of performance; and
3. The UCC.

Express Agreement

The general rule is that parties are free to make their own sales contract. When parties agree on terms–especially for quality, quantity, price, delivery and payment–those terms control over UCC provisions. The parties' freedom to contract, however, is not limitless. Parties cannot disclaim their obligation of good faith, diligence, and due care. Similarly, liquidated damages provisions must be based on the value of the contract and cannot be a penalty for breach of contract. Further, limitations on consequential damages cannot be unconscionable.

Course of Dealing, Usage of Trade & Course of Performance

The parties' agreement may be based on their actions. **Course of dealing** is an established pattern of prior conduct between the parties to a particular transaction. If a dispute arises, the parties' course of dealing can be used as evidence of how they intended to carry out the transaction. In other words, the current contract is interpreted based on past contracts.

Course of performance relates to the conduct of the parties under the contract in question after its formation. It occurs when a contract involves repeated performance and looks at how the parties have acted when performing this particular contract, not contracts in the past.

Usage of trade is a practice or custom in a particular trade used so frequently that it justifies the expectation that it will be followed in the current transaction. It is industry standards and customs related to a particular industry.

UCC Provisions

When sales contracts do not have all the necessary terms, the UCC "fills in the gaps" of the contract. The most important UCC gap-filler provisions relate to price, quantity, delivery, and time of performance.

Provision	Subject	Description
§2-305	Price	Price can be left open to be fixed at later time
		Reasonable price determined upon delivery "Output" and "Requirement" amounts can be determined at later time
§2-306	Quantity	No quantity that is unreasonably disproportionate to the estimate will be enforced
		Reasonable amount in keeping with normal or prior comparable output or requirements is implied
§2-507	Delivery	Delivery occurs at seller's place of business unless contract provides otherwise
§2-308/ §2-309	Time	Reasonable time for performance

Figure 11.2 UCC Gap-Filler Provisions

Provision	Subject	Description
§2-305	Price	Price can be left open to be fixed at later time; Reasonable price determined upon delivery
§2-306	Quantity	"Output" and "Requirement" amounts can be determined at a later time; No quantity that is unreasonably disproportionate to the estimate will be enforced; Reasonable amount in keeping with normal or prior comparable output or requirements is implied
§2-507 & §2-308	Delivery	Delivery occurs at seller's place of business unless contract provides otherwise
§2-309	Time	Reasonable time for performance

When these sources of contract terms are in conflict, the UCC applies the following hierarchy:

1. Express terms;
2. Course of performance;
3. Course of dealing;
4. Usage of trade; and
5. UCC gap-filler provisions.

The logic is that the parties are free to contract the terms they would like. In absence of an express agreement, the parties' conduct shows their intent. In practical terms, usage of trade and UCC provisions often go hand-in-hand. For example, what constitutes

“reasonable time” for performance is often based on relevant industry standards. Although the UCC identifies a hierarchy, in practice it is not rigidly applied by the courts when determining usage of trade and UCC provisions.

Additional and Different Terms

Under UCC §2-207, an acceptance that adds or alters terms will often create a contract. Unlike the common law that treats modifications as a counter-offer, the UCC has a more flexible concept of acceptance. This is to address the “battle of the forms” that happens when merchants buy and sell goods with pre-printed forms. Frequently buyers use pre-printed forms to place an order that are then acknowledged by the seller on its own pre-printed forms. These forms typically contain language favorable to the party sending it and rarely agree.

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A buyer has the right to inspect the goods before paying or accepting them. A buyer may also reject non-conforming goods by notifying the seller within a reasonable time.

If a buyer rejects the goods, the seller has the **right to cure**, which is the right to deliver conforming goods before the contract deadline. The UCC also allows the right to cure after the contract deadline in some situations. If the seller delivers conforming goods, then it is entitled to full payment under the contract.

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If the buyer has accepted the goods and refuses to pay, or if the goods are conforming but resale is impossible, the seller may sue the buyer for the contract price. This is common when the buyer orders goods with unique specifications.

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1. With an affirmation of a fact or a promise;
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To constitute a warranty, the seller's words or actions must be part of the basis of the bargain. For example, if a salesperson says that a car's timing belt was just replaced and will not need to be replaced for another 100,000 miles, and the buyer relied on that statement when deciding to buy the car, then the salesperson's statement becomes an express warranty.

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13.6: Concluding Thoughts

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CHAPTER OVERVIEW

14: Agency

Learning Objectives

- Know the basic principles of an agency relationship.
- Identify the different duties principals and agents owe each other.
- Understand the consequences of legal liability for principals regarding an agent’s actions.

14.1: Introduction
14.2: The Agency Relationship
14.3: Duties of Agents and Principals
14.4: Liability to Third Parties
14.5: Termination of Agency Relationship
14.6: Concluding Thoughts

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14.1: Introduction

Fundamentally, the principles of agency hold individuals and businesses liable for the acts of others. For example, if an employee uses a racial slur against a customer, the business is liable for that employee's discriminatory act. Likewise, if an agent signs a contract in the name of a business, that business may be bound by the terms of the contract.

Agents cannot give themselves power without the express or implied authority of the principal. Once an agency relationship is formed, agents and principals owe each other certain duties. This ensures fair dealings between them and gives third parties some assurance regarding their rights.

Counselor's Corner

Agency is not a sexy area of the law. Most people don't give much thought about it. But I often see cases in my courtroom where people and businesses are liable for the acts of their agents. It doesn't matter if you didn't know the person was legally your agent. You are still responsible for their actions under the law. While there is no way to prevent all mistakes and bad behavior of others, the best way you can insulate yourself from liability of an agent is to surround yourself with people who have integrity. If your grandmother wouldn't approve of them, then you shouldn't work with them. ~Christopher W., judge

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14.2: The Agency Relationship

An agency relationship is created when one person or entity agrees to perform a task for, and under the direction of, another individual or entity. An **agent** is the person who is authorized to act for or in place of another. A **principal** is the person who authorizes another to act on his, her, or its behalf as an agent.

Agency is a fiduciary relationship created by express contract or implied actions, in which the agent has the authority to act on behalf of the principal and legally bind the principal to third parties.

A **fiduciary relationship** is a relationship in which one person is under a duty to act for the benefit of the other on matters within the scope of the relationship. Fiduciary relationships require trust, good faith, and acting in the best interest of the other. In fiduciary relationships, the law requires the fiduciary to act with the highest duty of care. This means that the fiduciary must put the interests of the other party before their own. Examples of fiduciary relationships include doctor-patient, attorney-client, accountant-client, trustee-beneficiary, and guardian-child. An agent is also a fiduciary of a principal.

Types of Principals

There are three types of principals, which are described from the perspective of a third party: disclosed, partially disclosed, and undisclosed.

A **disclosed principal** is a principal whose identity is revealed by the agent to a third party. These are the most common types of principals. For example, employees work for a disclosed principal when they are on the employer's premise, wear a name badge or uniform identifying the employer, or answer the phone by identifying the employer's name.

A **partially disclosed principal** is a principal whose existence, but not actual identity, is revealed by the agent to a third party. In other words, a third party knows that the agent represents a principal but does not know the identity of the principal. For example, a realtor in Aspen may represent celebrities and wealthy individuals who want to purchase property but do not want the paparazzi to publicize the information.

An **undisclosed principal** is a principal whose identity is kept secret by the agent. Often third parties do not realize that an agency relationship exists and believe that the agent is working on his or her own behalf. Undisclosed principals occur when the identity of the principal can lead to increased purchase prices, unwanted publicity, and security concerns.

Types of Agents

An agent is someone who is authorized to act on behalf of a principal. Because there is a variety of authority that a principal can grant an agent, there are many different types of agents. In general, agents are described as either general or special. **General agents** have the authority to transact all the principal's business of a particular kind or in a particular place. General agents often include partners, managers, factors and brokers. **Special agents**, in contrast, only have the authority to conduct a particular transaction or to perform a specific act. Special agents often include realtors, athlete's agents, and employment recruiters.

Some of the most common business agents include:

Agent	Description
Broker	Receives a commission to make contracts with third parties on behalf of a principal
Business agent	Has general power involving the exercise of judgment and discretion, such as a manager or officer
Factor	Receives and sells goods or property for a commission
Forwarding agent	Receives and ships goods for a principal
Independent contractor	Exercises independent judgment on the means used to accomplish the result demanded by principal
Local agent	Acts as a representative to transact business within a specified area
Ordinary agent	Acts under the direction and control of the principal, such as an employee
Process agent	Authorized to accept legal service of process on behalf of the principal
Registered agent	Authorized to accept legal service of process for a corporation in a particular jurisdiction

Types of Authority

Authority is the right or permission to act legally on another's behalf. In general, authority can be either actual or apparent. **Actual authority**, sometimes called real authority, occurs when a principal intentionally confers authority on an agent. Actual authority can be either express or implied. **Express authority** is authority given by an express agreement, either orally or in writing. **Implied authority** is authority granted to the agent as a result of the principal's conduct.

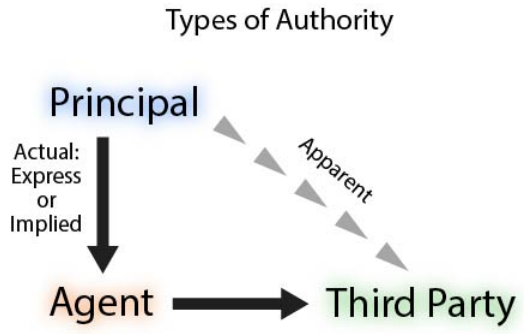


Figure 15.1 Types of Authority

Apparent authority is authority that a third party reasonably believes an agent has, based on the third party's dealings with the principal. If a principal's words or actions lead others to believe that he or she gave authority to someone else, then the principal is held accountable even if no authority was actually given to the agent. For example, if a principal fails to give notice that an agent is no longer working for the principal, the agent may still bind the principal through apparent authority when dealing with third parties.

To constitute apparent authority, three elements must be met:

1. The principal's words or actions lead others to believe the agent has authority;
2. A third party reasonably relies on the principal's words or actions; and
3. The third party is injured.

Sometimes an agent acts without authority. If a disclosed principal likes what an agent does, even if done without authority at the time, the principal can still benefit from the agent's actions. **Ratification** occurs when a disclosed principal adopts or confirms a

contract entered into on his or her behalf by an agent who did not have authority to act. Unlike apparent authority, the third party does not have to be injured. Rather, ratification allows principals to enter into contracts for their benefit. Ratification is an “all or nothing” doctrine that prevents principals from ratifying only part of the contract or renegotiating its terms.

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14.3: Duties of Agents and Principals

Because they are in a fiduciary relationship, agents and principals owe each other specific duties. While the duties are similar in nature, there are differences based on their roles.

Duties of Agents



Figure 15.2 Duties of Agents

Agents are fiduciaries of principals and so they are required to act with the highest duty of care. In particular, agents owe principals the following duties:

Duty	Description
Account	Agent must keep proper records to account for all principal's money and property given to agent
Care	Agent must act reasonably, in good faith, and avoid negligence at all times
Inform	Agent must inform principal of all material facts that affect principal's interests
Loyalty	Agent cannot engage in any dealings that compete or interfere with the principal's business or interests
Obedience	Agent must obey all principal's instructions within scope of agency unless they are illegal or unethical
Protect confidential information	Agent cannot use or disclose principal's confidential information

If an agent breaches a duty owed to the principal, the principal has three available remedies:

1. The principal may recover damages the breach has caused;
2. The principal may receive any profit the agent received as a result of a breach of the duty of loyalty; and
3. The principal may rescind a transaction when the duty of loyalty is violated.

Duties of Principals

Principals also owe duties to agents as part of the fiduciary relationship. These duties are:

Duty	Description
Compensation	Principal must pay agent for work performed
Honesty	Principals cannot deceive agents about the nature and scope of the work they are to perform
Indemnification	Principal must hold agent harmless and free from legal liability for actions properly taken on principal's behalf
Loyalty	Principal cannot engage in any dealings that prevent agent from performing agency tasks
Reimbursement	Principal must reimburse agent for money reasonably expended on behalf of principal



Figure 15.3 Duties of Principals

If a principal breaches a duty owed to the agent, the agent has two available remedies:

1. The agent may recover damages the breach has caused; and
2. The agent may terminate the agency relationship.

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14.4: Liability to Third Parties

An agency relationship affects liability to third parties. The scope of liability depends on the type of principal involved, the type of authority involved, and the nature of the dispute.

Contractual Liability

A principal is always liable on a contract if the the agent had authority. However, the agent's liability on a contract depends on how much the third party knows about the principal. Disclosure, when allowed by the principal, is the agent's best protection against legal liability.

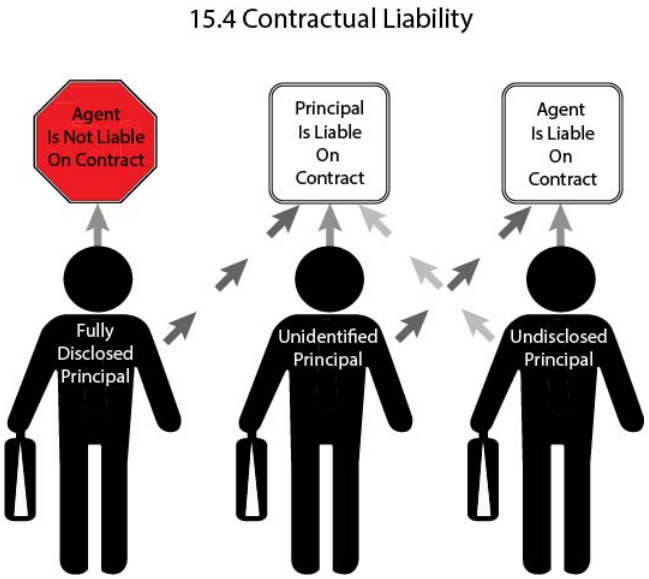


Figure 15.4 When Agents are Liable on Contracts

An agent is not liable for any contracts he or she makes with authority on behalf of a fully disclosed principal. Therefore, if a third party knows the existence and identity of the principal, then all legal liability lies with the principal. The only exception to this is when an agent exceeds his or her authority. In that case, the agent has not acted with authority and becomes personally responsible to the third party. If the agent did not have authority, but the principal later ratifies the contract, then the principal will be liable for the contract.

If a principal is partially disclosed, then the third party may recover from either the principal or agent. In this situation, the principal and agent are jointly and severally liable, and the third party may sue either or both of them to recover the full amount of damages owed. However, the third party cannot seek "double damages" and recover more than the total amount owed for the contractual breach.

In the event of an undisclosed principal, a third party may recover from either the agent or the principal. The fact that a principal's existence or identity is hidden from third parties does not change the nature of the agent-principal relationship. Therefore, undisclosed principals may become liable for contracts entered into by agents acting with actual authority. An undisclosed principal has no liability to an agent or third party when the agent exceeds the actual authority granted by the principal. In addition, the type of contract must be the type that can be assigned to the undisclosed principal. If the contract is for personal services, then liability cannot be assigned to the principal in case of a breach.

Tort Liability

Agents, employees, and independent contractors are personally liable for their own torts. This concept is rooted in the notion that every individual who commits a tort is personally liable to the party who is damaged by the tortious act. The law holds wrongdoers personally accountable.

However, the reverse is not true. Agents, employees, and independent contractors are not liable for the torts of the principal or employer. If a principal or employer is engaged in tortious behavior, its liability cannot be passed down to its agents and

employees.

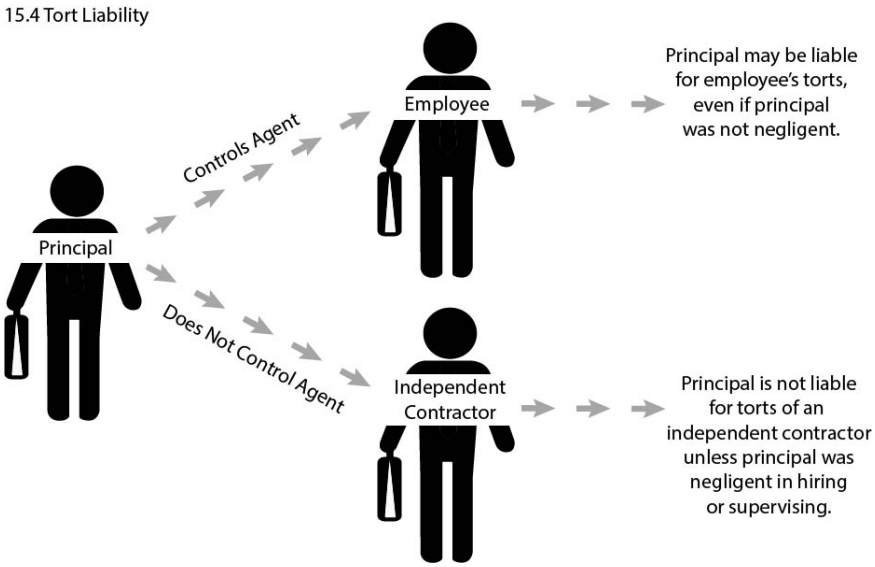


Figure 15.5 When Principals Have Tort Liability for Employees and Independent Contractors

An employer is liable for the torts of an employee if the employee is acting within the scope of employment. This doctrine is called **respondeat superior** and imposes vicarious liability on employers as a matter of public policy. Even if the employer does not direct its employees to act negligently or intentionally, the employer is responsible because employers are usually in a better position to pay for damages than employees. There is also a strong public policy consideration to not allow employers to turn a blind eye to an employee's bad behavior. By making an employer responsible for an employee's actions, it incentivizes the employer to address situations promptly that could lead to potential liability.

Conversely, a principal is not usually liable for the torts of an independent contractor. Independent contractors have the power to control the details of the work they perform and generally are only responsible to a principal for the results of their work. Therefore, independent contractors are not directed and controlled by a principal as employees are by their employers. As a result, the doctrine of respondeat superior does not apply to independent contractors.

Two exceptions exist that may impose liability on a principal for the work of an independent contractor. The first exception is where the work is inherently dangerous. Public policy prevents principals from insulating themselves from the risks of liability by selecting an independent contractor rather than an employee to perform the dangerous work. The second exception is where the work is illegal. Public policy also prevents principals from hiring independent contractors to perform a task that is illegal.

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14.5: Termination of Agency Relationship

Agents and principals may end their agency relationship in various ways. The most common way is through mutual agreement. As a matter of contract, principals and agents may decide to end their relationship. For example, an employee may decide to quit his or her job, or the agency agreement may only be for a set period of time or for a specific transaction.

In addition, there are some events that will terminate an agency relationship as a matter of law. Death of a principal or agent automatically terminates the agency agreement, even if the other party is unaware of the death. Once the time of death is established, any transactions afterward are deemed void.

Similar to death, mental incapacity of a principal or agent terminates an agency relationship. It is often hard to determine the precise time someone loses mental capacity. Therefore, courts often hold that an agent's contract with a third party is binding on the principal unless the third party was aware of the principal's incapacity.

Bankruptcy terminates an agency relationship when the bankruptcy affects the subject matter of the agency agreement. For example, if a principal declares bankruptcy and the real property that an agent is authorized to sell is part of the bankruptcy estate, then the bankruptcy will automatically terminate the agency relationship.

Finally, the destruction or illegality of the subject matter will terminate the agency relationship. For example, if Congress passes a law making it illegal for private parties to sell specific types of weapons, the agency relationship between a gun dealer and its factor for selling those weapons will automatically end.

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14.6: Concluding Thoughts

Agency relationships are flexible and varied depending on the needs and interest of the principals and agents. Because the agency relationship is fiduciary in nature, agents and principals owe each other certain duties. Third parties may hold principals legally liable for the actions of their agents. Therefore, it is important for businesses to select their agents carefully to minimize their risk of liability.

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CHAPTER OVERVIEW

15: Business Organizations

Learning Objectives

- Know the available entity choices when forming a business.
- Identify the factors that determine entity selection.
- Understand common business entities and their advantages and disadvantages.

15.1: Introduction
15.2: Sole Proprietorship
15.3: Partnerships
15.4: Franchises
15.5: Joint Venture
15.6: Corporations
15.7: Limited Liability Entities
15.8: Concluding Thoughts

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15.1: Introduction

At its most fundamental level, a business exists to make a profit for its owners. Some businesses make things in factories (manufacturers), other businesses sell things that other businesses make (retailers), and still other businesses exist to help both the makers and sellers make and sell better (business consultants). Some businesses don't make things at all, and instead profit by selling their services or by lending money.

With this diversity, it's not surprising that there is no "one size fits all" approach to choosing a business organization. When choosing what form of entity is best, several factors are important to consider:

1. How much it costs to create the entity and how hard it is to create.
2. How easy it is for the business to continue if the founder dies or retires.
3. How difficult it is to raise money to grow or expand the business.
4. What type of managerial control they wish to keep on the business, and whether they are willing to cede control to outsiders.
5. If expanding ownership to members of the public is desired.
6. How to minimize the taxes paid on earnings and income.
7. How to protect personal assets from claims, a feature known as limited liability.

Depending on the type of business and its goals, different business entities may be appropriate.

Counselor's Corner

Selection of business entities is often the first step when going into business. Many entrepreneurs and small businesses do not spend enough time thinking about the legal and tax consequences of the entity they choose. Ironically, an important discussion to have at the beginning is an exit strategy. What happens if one of the business owners becomes ill, dies, or wants to leave the business? What if the economic situation changes and the business no longer is profitable? Discussing exit strategies up front helps people make the best decisions when crises happen. Don't avoid hard conversations up front. It may be uncomfortable but will save a lot of problems down the road. ~Allison W., attorney

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15.2: Sole Proprietorship

A **sole proprietorship** is an unincorporated business owned by one person or married couple. The legal name for a sole proprietorship is usually the owner's name.

There are many advantages to doing business as a sole proprietor. First, it's easy to create a sole proprietorship. In effect, no creation costs or time is required because there is nothing to create. The entrepreneur in charge of the business simply starts doing business, charging money, and providing goods or services.

Another key advantage to sole proprietorship is autonomy. The owner can decide how he or she wants to run the business. The owner can set her own hours, grow as quickly or slowly as she wants, and expand into new lines of businesses. That autonomy also comes with total ownership of the business's finances. All the money that the owner takes in, even if it is in a separate bank account, belongs to her, and she can do with that money whatever she wants.

A sole proprietorship is a **flow-through tax entity**, which means the business does not pay tax on its profits and does not file a separate tax return. Instead, the owner pays personal income tax on all business profits.

These advantages must be weighed against some disadvantages. First, because a sole proprietorship can have only one owner, it is impossible to bring in others to the business. In addition, the business and the owner are identical so it is impossible to pass on the business.

Raising working capital can be a problem for sole proprietors, especially those early in their business ventures. Many entrepreneurial ventures are built on great ideas but need capital to flourish and develop. If the entrepreneur lacks individual wealth, then he or she must seek those funds from other sources. Outsiders can make a loan to the owner, or enter into a profit-sharing contract with her, but there is no way for him to own any part of the owner's business. Traditionally, most sole proprietors seek funding from banks. Banks approach these loans just like any other personal loan to an individual, such as a car loan or mortgage. Down payment requirements may be high, and typically the banks require some form of personal collateral to guarantee the loan, even though the loan is to be used to grow the business.

Sole proprietors are personally liable for all the business's debts and obligations. Unlimited liability puts all the personal assets of the sole proprietor at risk. Personal homes, automobiles, bank accounts and retirement accounts—all are within reach of creditors.

Advantages of Sole Proprietorship	Disadvantages of Sole Proprietorship
• Easy to create • No formal documents or governmental filings required to start business • No formation start up costs • Autonomy • Total control over finances and management decisions	• Flow-through tax entity (owner pays personal income tax on all business profits) • Cannot bring someone else into business • Impossible to pass on the business • Hard to raise capital • Unlimited liability

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15.3: Partnerships

A **partnership** is an unincorporated association of two or more co-owners who operate a business for profit. Each owner is called a **general partner**.

General Partnerships

A **general partnership** is when all partners participate fully in running the business and share equally in profits and losses, even if the partners' monetary contributions vary. No legal documents are required to file with the government to form a partnership. If two or more people do business together, sharing management of the business, profits and losses, they have a partnership.

If a partnership is formed formally, then the written agreement is called the **articles of partnership**. The articles can set forth anything the partners wish to include about how the partnership will be run. Normally, all general partners have an equal voice in management, but as a creation of contract, the partners can modify this if they wish.

A general partnership is taxed just like a sole proprietorship. A partnership is a **flow-through tax entity**, where the partnership's income "flows through" the business to the partners, who then pay individual tax on the business income. The partnership may file an information return, reporting total income and losses for the partnership, and how those profits and losses are allocated among the general partners. However, an information return is usually not required.

General partnerships are also similar to sole proprietorships in unlimited liability. Every partner in the partnership is jointly and severally liable for the partnership's debts and obligations. This is a very unattractive feature of general partnerships. One partner may be completely innocent of any wrongdoing and still be liable for another partner's malpractice or bad acts.

General partnerships are dissolved as easily as they are formed. Since the central feature of a general partnership is an agreement to share profits and losses, once that agreement ends, the general partnership ends with it. In a general partnership with more than two persons, the remaining partners can reconstitute the partnership if they wish, without the old partner. A common issue that arises in this situation is how to value the withdrawing partner's share of the business. Articles of partnership therefore typically include a buy/sell agreement, setting forth the agreement of the partners on how to account for a withdrawing partner's share, which the remaining partners then agree to pay to the withdrawing partner.

Management Duties

Partners have a **fiduciary duty** to the partnership. This means that partners have a duty to act for the benefit of the partnership. In particular:

- Partners have an obligation of good faith and fair dealing with each other and the partnership.
- Partners are liable to the partnership for gross negligence or intentional misconduct. Partners are not liable for ordinary negligence.
- Partners cannot compete with the partnership.
- Partners cannot take opportunities away from the partnership unless the other partners consent.
- Partners cannot engage in conflicts of interest.

Limited Partnerships

In most states, owners can form a limited partnership. A **limited partnership** has both general partners and limited partners. As a limited partner, the most he or she can lose is the amount of his investment into the business, nothing more. Limited partnerships have to be formed in compliance with state law, and limited partners are generally prohibited from participating in day-to-day management of the business. This often occurs when someone invests money in the partnership but is not interested in running the business.

Advantages of Partnerships	Disadvantages of Partnerships
• Easy to create • No formal documents or governmental filings required to start business • Flexibility in sharing management decisions • Allows for investment by limited partners to raise capital • Easy to dissolve	• Flow-through tax entity (owner pays personal income tax on all business profits) • Unlimited liability • May be hard to value individual partner's share of business • Dissolution occurs any time a new partner is added or old partner leaves

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15.4: Franchises

A **franchise** is when a business grants to another the sole right of engaging in a certain business or in a business using a particular trademark in a certain area. Franchises are not a separate form of business organization. Rather, they are a form of contract between businesses. Most franchises involve corporations or limited liability corporations, but they may include sole proprietorships and partnerships.

The advantage of a franchise is that under a **franchise agreement**, an entrepreneur can open and run a business under a proven business model. The local owner, the **franchisee**, uses the **franchisor's** trademark, intellectual property, and business model under a license agreement. The franchisee offers goods or services to the public and keeps any income earned. In exchange for the right to sell goods or services developed by the franchisor, the franchisee pays a fee to the franchisor.

Franchises are common in some industries such as fast food restaurants, hotels, and tax preparation services. Franchise agreements are very detailed and often require the franchisee to use specific vendors, ingredients, store layouts, colors, etc.

Franchises are also very popular with US businesses interested in conducting business abroad. US businesses collect franchise fees from owners in other nations who are responsible for running the business abroad. This allows US companies to have a presence in nations that may restrict business ownership by foreigners because the businesses themselves are owned and operated by locals.

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15.5: Joint Venture

A **joint venture** is when two or more individuals or businesses combine their efforts in a particular business enterprise and agree to share the profits and losses jointly or in proportion to their contributions. Unlike a partnership, which operates as a general business for as long as the partners desire, a joint venture is for a single transaction or a limited activity. The businesses remain separate entities and they do not share financial or confidential information unless they decide to. Joint ventures automatically terminate at the conclusion of an event or project.

Joint ventures are often formed to address a common need or to reach a mutual goal. For example, Google and National Aeronautics and Space Administration (NASA) developed Google Earth as a joint venture. To do so, they shared resources and information necessary to develop Google Earth but Google did not become part of the government, nor did NASA share any confidential information or intellectual property more than necessary.

Joint ventures are also common to share the costs of major research or infrastructure projects within an industry. This occurs frequently when industries are impacted by advances in technology. For example, BMW and Toyota created a joint venture to research hydrogen fuel cells, electric vehicles, and ultra-lightweight materials needed in next generation vehicles. By sharing the cost of research and development, the companies are able to be on the forefront of technological advancements in their industry.

Franchises	Joint Ventures
• The right to use a trademark by paying a fee to the franchisor • Contract isn't separate from the business • Franchise either offers a good or a service • Mainly used in conducting business abroad	• Share a mutual goal/cost/losses • Combines efforts in a single transaction or a limited activity • Agreement becomes terminated at the end of the event or project • Financial and confidential information is not shared

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15.6: Corporations

Unlike a sole proprietorship or general partnership, a corporation is a legal entity separate and distinct from its owners. It can be created for a limited duration, or it can have a perpetual existence. Since it is a separate legal entity, a corporation has continuity regardless of its owners. Similarly, in a publicly traded company, the identity of shareholders can change, but the corporation continues its business operations without being affected.

Corporations must be formed in compliance with the law of the state law where they are incorporated. Most corporations incorporate where their principal place of business is located, but not all do. Many companies choose to incorporate in Delaware. Delaware chancery courts have developed a reputation for fairly and quickly applying a very well-developed body of corporate law in Delaware. The courts also operate without a jury, meaning that disputes heard in Delaware courts are usually predictable and transparent, with well-written opinions explaining how the judges decided the cases.

To start a corporation, the corporate founders must file **articles of incorporation** with the Secretary of State where they are incorporated. Articles of incorporation typically include:

- The name of the company;
- Whether the company is for-profit or nonprofit;
- The founders' names;
- The company's purpose;
- How many shares the corporation will issue initially; and
- The par value of any shares issued.

Unlike sole proprietorships, corporations can be quite complicated to manage and often require attorneys and accountants to maintain corporate books in good order. In addition to the foundation requirements, corporate law requires ongoing annual maintenance of corporations. In addition to filing fees due at the time of incorporation, there are typically annual license fees, franchise fees and taxes, and fees related to maintaining minute books, corporate seals, stock certificates and registries, as well as out-of-state registration. A domestic corporation is entitled to operate in its state of incorporation but must register as a foreign corporation to do business in other states.

Corporate Legal Structure

Owners of corporations are called **shareholders**. Corporations can have as few as one shareholder or as many as millions of shareholders, and those shareholders can hold as few as one share or as many as millions of shares. In a **closely held corporation**, the number of shareholders tends to be small, while in a **publicly traded corporation**, the body of shareholders tends to be large.

In a publicly traded corporation, the value of a share is determined by the laws of supply and demand, with various markets or exchanges providing trading space for buyers and sellers of certain shares to be traded. Shareholders own shares in the company but have no legal right to the company's assets. As a separate legal entity, the corporation owns any property in its name.

Shareholders of a corporation enjoy limited liability. The most they can lose is the amount of their investment. Shareholders' personal assets are not available to the corporation's creditors.

Shareholders can be individuals or other business entities, such as partnerships or corporations. If one corporation owns all the stock of another corporation, the owner is said to be a **parent company**, while the company being owned is a **wholly owned subsidiary**. Often large corporations form subsidiaries for specific purposes so that the parent company has limited liability or advantageous tax treatment. For example, large companies may form subsidiaries to hold real property so that premises liability is limited to that real estate subsidiary only, shielding the parent company and its assets from lawsuits. Companies that deal in a lot of intellectual property may form subsidiaries to hold their intellectual property, which is then licensed back to the parent company so that the parent company can deduct royalty payments for those licenses from its taxes. This type of sophisticated liability and tax planning makes the corporate form very attractive for larger businesses in the United States.

An exception to the rule of limited liability arises in certain cases involving closely held corporations. Many sole proprietors incorporate their businesses to gain limited liability but fail to realize when they do so that they are creating a separate legal entity that must be respected as such. If sole proprietors fail to respect the legal corporation with an arm's length transaction, then

creditors can ask a court to pierce the corporate veil. If a court agrees, then limited liability disappears and those creditors can reach the shareholder's personal assets.

Rights of Shareholders

Not all shareholders in a corporation are necessarily equal. US corporate law allows for the creation of different types, or classes, of shareholders. Shareholders in different classes may be given preferential treatment when it comes to corporate actions such as paying dividends or voting at shareholder meetings.

Shareholder rights are generally outlined in a company's articles of incorporation or bylaws. Some of these rights may include the right to obtain a dividend, but only if the board of directors approves one. They also include the right to attend shareholder meetings, the right to examine the company's financial records, and the right to a portion of liquidated company assets.

Under most state laws, shareholders are also given a unique right to sue a third party on behalf of the corporation. This is called a **shareholder derivative lawsuit**. In essence, a shareholder alleges that the people who are ordinarily charged with acting in the corporation's best interests (the officers and directors) are failing to do so, and therefore the shareholder must step in to protect the corporation.

One of the most important functions for shareholders is to elect the board of directors of a corporation. Only shareholders elect a director. The board is responsible for making major decisions that affect a corporation, such as declaring and paying a corporate dividend to shareholders; authorizing major decisions; appointing and removing corporate officers; determining employee compensation, especially bonus and incentive plans; and issuing new shares and corporate bonds.

One critical function for boards of directors is to appoint corporate officers. These officers often hold titles such as chief executive officer, chief operating officer, chief marketing officer, and so on. Officers are involved in everyday decision making for the company and implement the board's decisions. As officers of the company, they have legal authority to sign contracts on behalf of the corporation, binding the corporation to legal obligations. Officers are employees of the company and work full-time for the company, but can be removed by the board.

Corporate Taxation

Corporations are subject to double taxation. Because corporations are separate legal entities, they must pay federal, state, and local tax on net income. Then, if the board of directors declares a dividend, shareholders are taxed on the dividend that they receive in the form of a dividend tax.

One way for closely held corporations (such as small family-run businesses) to avoid double taxation is to form an S corporation. An S corporation (the name comes from the applicable subsection of the tax law) can choose to be taxed like a partnership or sole proprietorship. In other words, taxes are only collected when a dividend is declared and not on corporate net income. An S corporation is formed and treated just like any other corporation; the only difference is in tax treatment.

S corporations provide the limited liability feature of corporations but the single-level taxation benefits of sole proprietorships. There are some important restrictions on S corporations, however. They cannot have more than one hundred shareholders, all of whom must be US citizens or resident aliens and cannot include partnerships and corporations. S corporations can have only one class of stock and there are restrictions on how shares may be transferred. Finally, all shareholders must agree that the company should be an S corporation. These restrictions ensure that "S" tax treatment is reserved only for small businesses.

Advantages of Corporations	Disadvantages of Corporations
• Separate legal entity from owners • Corporation unaffected by change of ownership/shareholders • Limited liability for shareholders • Not subject to some laws • Considered as an "individual" with Constitutional rights	• Formal documents required to filed in state of incorporation • Can be complicated to manage • High formation and maintenance costs • Subject to double taxation • Heavily regulated by government

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15.7: Limited Liability Entities

A **limited liability company (LLC)** is a "hybrid" form of business organization that offer the limited liability feature of corporations but the tax benefits of partnerships. Owners of LLCs are called **members**. Just like a sole proprietorship, it is possible to create an LLC with only one member. LLC members can be individuals or other LLCs, corporations, or partnerships. LLC members can participate in day-to-day management of the business.

Members are not personally liable for the debts of the business. Like shareholders of a corporation, members of an LLC risk only their financial investment in the company.

Taxation of LLCs is very flexible. Every year the LLC can choose how it will be taxed. It may want to be taxed as a corporation, for example, and pay corporate income tax on net income. Or it may choose instead to have income "flow through" the corporate form to the member-shareholders, who then pay personal income tax just as in a partnership. Sophisticated tax planning becomes possible with LLCs because tax treatment can vary by year.

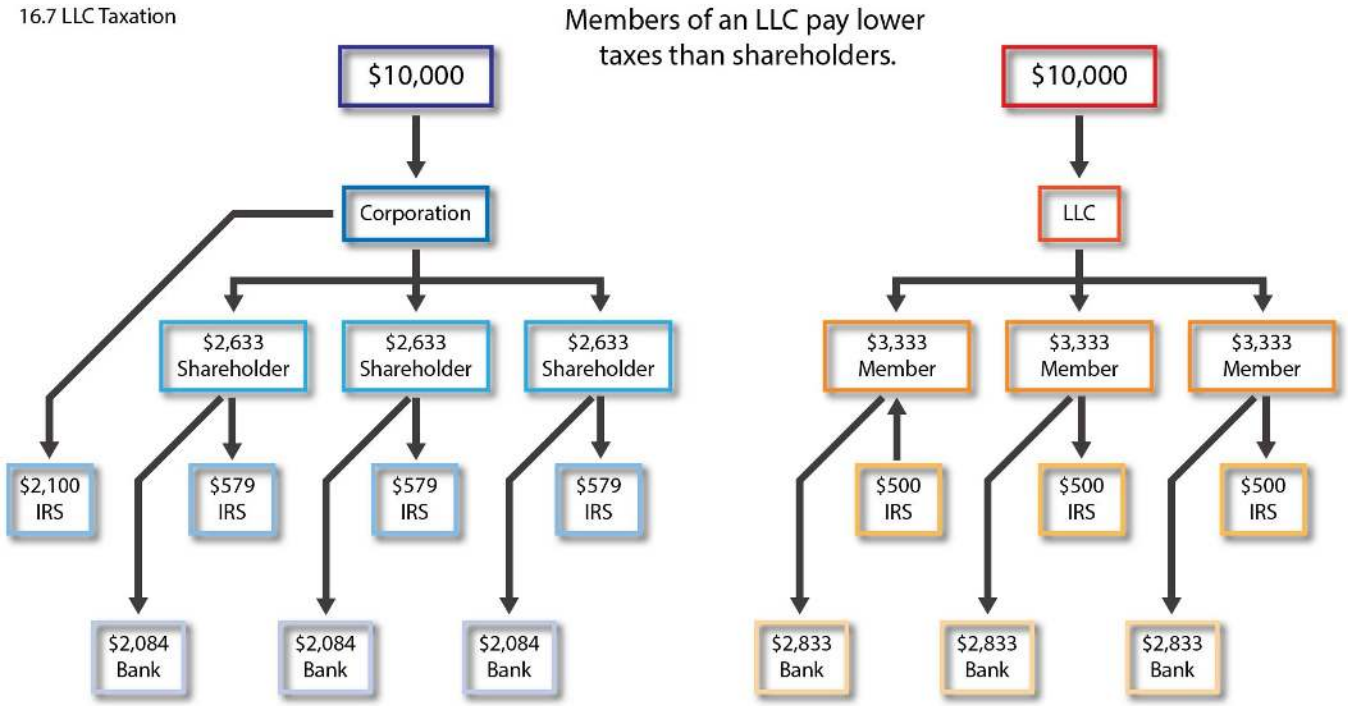


Figure 16.1 LLC Taxation

LLCs are formed by filing the articles of organization with the state agency charged with chartering business entities, typically the Secretary of State. Starting an LLC is often easier than starting a corporation. Typical LLC statutes require only the name of the LLC and the contact information for the LLC's legal agent. Unlike corporations, there is no requirement for an LLC to issue stock certificates, maintain annual filings, elect a board of directors, hold shareholder meetings, appoint officers, or engage in any regular maintenance of the entity. Most states require LLCs to have the letters "LLC" or words "Limited Liability Company" in the official business name.

Although the articles of organization are all that is necessary to start an LLC, it is advisable for the LLC members to enter into a written LLC operating agreement. The operating agreement typically sets forth how the business will be managed and operated. It may also contain a buy/sell agreement just like a partnership agreement. The operating agreement allows members to run their LLCs any way they wish.

Since LLCs are a separate legal entity from their members, members must take care to interact with LLCs at arm's length, because the risk of piercing the veil exists with LLCs as much as it does with corporations. Fundraising for an LLC can be as difficult as it is for a sole proprietorship, especially in the early stages of an LLC's business operations. Most lenders require LLC members to personally guarantee any loans the LLC may take out. Finally, LLCs are not the right form for taking a company public and selling

stock. Fortunately, it is not difficult to convert an LLC into a corporation, so many start-up business begin as LLCs and eventually convert into corporations prior to their initial public offering (IPO).

Advantages of LLCs	Disadvantages of LLCs
• Limited liability for owners • Flow-through tax entity so not subject to double taxation • Easier to form and operate than corporation or S corporation • Owners can deduct losses for personal taxes	• Subject to state laws so lacks consistency in enforcement • Laws not as developed as corporate law & partnership law

Limited Liability Partnerships

A related entity to the LLC is the limited liability partnership, or LLP. Be careful not to confuse limited liability partnerships with limited partnerships. LLPs are just like LLCs but are designed for professionals who do business as partners. They allow the partnership to pass through income for tax purposes, but retain limited liability for all partners. LLPs are especially popular with doctors, architects, accountants, and lawyers. Most of the major accounting firms have now converted their corporate forms into LLPs.

Professional Corporations

Professional Corporations (PCs) are mostly a legacy form of organization. In other words, before LLCs and LLPs were an option, PCs were the only option available to professionals who wanted limited liability. Some states still require doctors, lawyers, and accountants to organize as a PC.

If a member of a PC commits malpractice, the PC's assets are at risk along with the personal assets of the member who committed malpractice. However, the personal assets of the non-involved members are not at risk. PCs do not shield individuals from their own malpractice but they offer limited liability to innocent members.

PCs are a separate taxable entity but they are not flow-through entities like partnerships. As a result, taxation of PCs is complicated and a major drawback of this form of business entity.

Type of Business Organization	Ease of Formation	Funding	Personal Liability for Owners	Taxes	Ease of Transferring Ownership	Perpetual Existence	Dissolution
Sole Proprietorship	Very easy	Same as owner	Yes	Flow-through	Must sell entire business	No	When & how owner decides
General Partnership	Easy	Partners contribute capital	Yes	Flow-through	Hard	No	Upon death, bankruptcy, agreement, or termination of partnership
Limited Partnership	Easy	Partners contribute capital	General partner is personally liable; limited liability for limited partners	Flow-through	Hard	No	Upon death, bankruptcy, agreement, or termination of partnership
Corporations	Difficult	Sell stock to raise capital	No	Subject to double taxation	Easy	Yes	By resolution of board of directors, bankruptcy, or court order
S Corporations	Difficult	Sell stock to raise capital	No	Taxed only on dividends	Transfer restrictions	Yes	By resolution of board of directors, bankruptcy, or court order
Limited Liability Companies (LLCs)	Medium	Members make capital contributions	No	Flow-through	Depends on operating agreement	Varies by state; yes in most states	Upon death, bankruptcy, agreement, or court order
Limited Liability Partnerships (LLPs)	Difficult	Members make capital contributions	Non-acting partners have limited liability; state law varies regarding liability of acting partners vs. partnership	Flow-through	Depends on the partnership agreement	Depends on partnership agreement	Upon death, bankruptcy, agreement, or termination of partnership
Professional Corporations	Difficult	Members make capital contributions	No	Complex tax issues	Transfer restricted to members of the same profession	Yes, as long as it has shareholders	Upon death, bankruptcy, agreement, or court order

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15.8: Concluding Thoughts

Depending on a business's type and goals, different business entities may fit the needs of owners better than others. It is important when starting a business to decide how to minimize tax and liability exposure and to maximize profits. Because there is no perfect "fit" for every business need, understanding the advantages and disadvantages of the various business entities is important.

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